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**SMALL BUSINESS IN RUSSIA: THE CASE  
OF ST. PETERSBURG**

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**Ph.D. thesis**

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April 2000

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**TO MY BROTHER AND MY FATHER**



## ABSTRACT

The thesis is about the development of small businesses in Russia with a focus on St. Petersburg. Any analysis on this sector is hindered by question marks over the reliability of the official data. While these point to a stagnation in the small business sector, surveys indicate a continuous growth in the share of the economy represented by new firms. How to reconcile these two sets of data is hard given the dearth of evidence. It seems, however, clear that even in Russia the emergence of new private firms has been an organic process which has been slower due to a variety of factors that have characterised the transition process: the strong influence of interest groups; the legislative chaos; the punitive taxation; the unpredictable economic environment; the scarcity of financing and the precarious state of large industrial firms. Mainframe small business theory can, instead, offer little explanation given the particular conditions of the transition from a planned to a market economy. By Russian standards, St. Petersburg has experienced a very large growth in the small business sector, despite the fact that the business environment in St. Petersburg does not differ from that in Russia in general and incomes per capita are close to the Russian average. This is in contrast to Moscow where the expansion of small businesses can be ascribed to the much higher income levels. In St. Petersburg the local administration has not been particularly business-friendly, dispensing favours to its "cronies" and doing little to rein in bureaucratic abuses. Policy making in industry has been centred, in particular, on helping certain sectors deemed as priorities, but the efficacy of these measures is doubtful at best. Economic policies in St. Petersburg may be seen as being shaped by the mentality of a planned economy, reflected in the drafting of countless plans and measures, which have, however, largely remained unrealised. Little has, instead, been done to meet small businesses demands. Nevertheless, from the survey I undertook and from other sources small businesses in St. Petersburg seem to perform much better than in the rest of the country. The higher educational level and the "Western mentality" of the population has represented a fertile environment

for the emergence of entrepreneurship. The expansion of the small business sector has been boosted by the larger retail spending per head than in Russia as a whole due a variety of factors. This explains why growth has been particularly strong in the service sector. On the contrary, despite the wealth of scientific knowledge in the city, scientific firms have not developed to any great extent. The difficult environment for scientific firms is highlighted by the experience of science parks. Even if there are some success stories the average tenant firm struggles to survive due to the limited demand for scientific products.

## Acknowledgments

I am greatly indebted to my two supervisors Richard Berry and Professor Roderick Martin for all the assistance they gave to me and for the patience they demonstrated throughout these years. They were always very friendly and supportive and their influence will play a part in my future research.

I also wish to thank my former supervisor Professor Tauno Tiusanen who accepted me in the first place and Professor John Löwenhardt, the current head of the department for giving me the opportunity to improve my public speaking. My gratitude goes also to Kay McWalter who always tried her best to answer the questions which periodically I would pose to her. I am also grateful to Junior Davis, previously at Herriot Watt University, who took the burden of reading some of my chapters and made useful comments.

The citizens of St. Petersburg were extremely warm and helpful as only Russians can be. For this reason my frequent stays in the Russian northern capital were always pleasant and interesting in addition to being productive. The people of St. Petersburg who received and helped me are so many that I am sure that I fail to mention some. Special recognition goes to Oleg Melnikov and Igor Zaitsev who were always friendly and dedicated, meeting me whenever I needed them. I am grateful to all the people who filled out my questionnaire. I feel a little bit guilty towards Ilya Karasev because his reply was incredibly detailed, replete with so many firms that it must have distracted him from his occupation for many hours. Among the other people who responded to my questionnaire I wish to thank Elena Danishevskaja who shared her experience of financing small businesses during our encounters; Sergei Siling who tried to recruit respondents at a seminar of the small business exhibition in 1998 and Vladimir Tul'vert for his availability when I needed to meet him. Elena Rabizo, a friend and accountant, gave me a detailed picture of the small firms in which she had worked. Larisa Kushnarenko a friend as well and a consultant who worked in the area for a long time, gave me a picture of the problems small

businesses had to encounter. Elena Belova, Lev Savulkin, Vladlena Yeliseeva, and Natalia Bagrova helped me to gain a better insight in St. Petersburg affairs.

In St. Petersburg I am also grateful to Aleksandr Barbanel, Jury Blinov, Kim Carlton, J.A. Duffy, Nikolai Ermilov, Constantin Eskin, Valentine Galenko, Sergei Gavrilov, Elena Iundina, David Kerry, Alexander Kizhin, Igor Lonsky, Alexander Nekludov, Albina Nikkonen, Yuri Nurulin, Thomas Oetter, Roman Pastukhov, Neil Ramsden, Boris Salov, Boris Novikov, Olga Seliuk, Vladimir Spivak, Charles Towers-Clerk Beso, and Joseph Tukkell. In Moscow Vladimir Buyev, Andrei Orlov and Tatiana Alimova shared their knowledge of the small business sector with me. In Milan Ms Rozzani of the Bocconi University was a precious source of contact with Russian researchers.

Finally I have to acknowledge the managing staff of the hostel of the University of Economics and Finance who always found a place for me and tried to arrange a quiet room knowing how sensitive I am to noises and the firm I was working for during most of my research for trying to meet my research commitments by allowing me to go on holidays whenever I needed to go to St. Petersburg.

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## LIST OF ABBREVIATIONS

EBRD	European Bank for Reconstruction and Development
Federal Fund	Federal Fund for Small Business Support
ICS	Innovation Centre located in the Svetlana factory
ICTU	Innovation Centre of the Technical University
Regional Fund	Regional Fund for the Scientific and Technological Development of St. Petersburg
SMEs	Small and medium enterprises
State Fund	State Fund for the Support and Development of Small Business in the Scientific and Technological Sphere
TEEU	Science Park of the Electrical Engineering University
TTU	Science Park of the Technical university
USAID	United States Agency for International Development

### Exchange rate utilised

(Rouble/dollar)

1992: 0.222

1993: 0.933

1994: 2.205

1995: 4.562

1996: 5.126

1997: 5.785

1998: 9.965

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# **INTRODUCTION TO THE THESIS**

## **OBJECTIVES**

This research is an original work on the development of small business in Russia with a focus on St. Petersburg. I am building on an established body of research on small business which has been carried out before in St. Petersburg by Webster and Charap in 1992 (survey of 100 private manufacturing firms), by De Melo and Ofer in 1993 (survey of eighty-six private service firms) and by the Leontief Center in more recent years. Concerning Russia in general many more studies have been carried out. The changes taking place in Russia have provided a myriad of opportunities for small business, so it is intriguing to find out why development has been so disappointing in contrast to the leading transition countries (Poland, Hungary and the Czech Republic). Evidence from Poland has suggested that the main engines of economic growth have been the new private enterprises created from scratch. The development of the small business sector seems to have been an organic process once economic freedom was conceded, thus not requiring any significant help from the state. Why does Russia differ? The unique factor about Russia is the weak role of entrepreneurs, even before the communist take-over, combined with a strong bureaucratic tradition. Is this adequate to explain its lack of dynamism or do other factors also have to be taken into consideration? The explanation may lie in a less business-friendly system of cultural rewards and sanctions, a less supportive government policy, the inadequacy of legislation, greater monopoly power, the absence of start-up finance, less developed informal networks, the more severe economic conditions, or the existence of substantial bureaucratic obstacles.

I have chosen to examine developments in St. Petersburg because it seemed to be one of the most appropriate places where small business could progress in Russia. St. Petersburg represents the most European part of Russia with a highly-educated population. It is a leading industrial centre

with a high share of high-technology industries, most of which formerly belonged to the military industrial complex. Several international programmes to promote entrepreneurship have been established in St. Petersburg. It is also one of the most liberal cities in Russia, having always returned pro-reform majorities since the first free elections in the early nineties. Even in Soviet times the city had a tradition of being strongly reformist and tried to follow its own path of development. Since the 1950s specific programmes were devised by local authorities to foster innovation in industry. For these reasons it is reasonable to expect that economic reforms would take root more easily in St. Petersburg compared with the rest of the Russian Federation, and consequently create a favourable environment for the development of entrepreneurship.

However, the lack of reliable information hinders the analysis of small business activity. In examining official statistics it is possible to identify several inconsistencies in the data. The interpretation of official data can sometimes be a hazardous exercise, requiring field work in order to provide a more reliable picture. A lot of effort was put in devising a questionnaire which could provide an adequate picture of the small business sector in Russia. This was initially intended to be distributed to individual entrepreneurs via an Italian researcher with contacts in St. Petersburg who promised to give me her assistance. Since after a while she lost interest in the project it became impossible to contact the requisite number of entrepreneurs without a base in the city. I therefore contacted organisations promoting small businesses. Despite the efforts in the end the replies were fewer than expected, but the number of firms they refer to is quite substantial. Even if this cannot be considered a representative sample, the evidence collected can, however, give useful insights into issues not covered by official statistics: in particular the origins of these small businesses, their main clients and markets, their purchases, etc. It was also deemed desirable to ascertain these organisations' opinions as to the constraints facing the small business sector, opinions which do not necessarily correspond with those of small business owners themselves, and

to gather the information on the status of small businesses in the city which could be a clue as to why so fast small business has expanded. The evidence covers almost exclusively start-ups. More studies must be done to have a more complete picture of the new firms sector in Russia in order to compare the results of this research with analogous studies regarding other cities. Qualitative interviews were also utilised in order to obtain a first-hand account of the business environment within which small businesses operate. Interviews were carried out with many economic actors; not all are reported in the study, but nevertheless most provided useful feedback. The study of science parks is used to analyse how science firms are faring in St. Petersburg and to ascertain whether this structure is the most appropriate to foster the creation and development of small businesses.

The research is reported in eight chapters. Firstly, I analyse the changing role of small business in the economic structure, the main theories on entrepreneurship and the development of small business in Eastern Europe and in Russia. Those aspects of small business theory which are more appropriate in the Russian context are then assessed in this section together with the economic theories which may explain why entrepreneurship has not made much progress in Russia. The basis on which the new private sector started to develop in the Soviet economy, and the role it was expected to have in the command economy as opposed to the role it actually had is also examined. Secondly, I show which aspects of the business environment have encouraged or, more usually, discouraged the development of small business and how the government has addressed the issue of small business in the post-communist period. Have macroeconomic issues deflected its attention as in other countries? If in Western countries the efficacy of a focused policy on small business is subject to criticism, the state in post-communist societies has an important role to play in creating the conditions for small business development: the financial sector has to be reformed; there is a great need for consulting due to the lack of business skills such as marketing and finance; an appropriate legislative framework has to be put in place, etc. A comparison is also made between Russia and

the leading transition countries regarding the factors which explain the poorer performance of the economy and of the small business sector in Russia - the two are correlated. Thirdly, I examine the official statistics relating to small business and the different methods used to collect data. I critically assess their reliability at national and local level comparing them with other data, when it is available. The importance of the small business sector in the city will be assessed taking on board the drawbacks of the frequently contradictory data. Fourthly, the impact of the economic crisis on the present economic structure of St. Petersburg is reviewed. The legacy of the communist past implies that national problems are exacerbated in St. Petersburg because the economic structure was orientated towards the production of military equipment. This chapter includes sections on the city budget, local political developments, but the bulk of the chapter is devoted to local economic policies. Local administrations have faced exceptional difficulties especially at the beginning of the transition, when the federal government retreated from particular areas and they have had to address a wide range of new problems in a situation of severe economic depression. Chapter five deals with local policy in the small business field in St. Petersburg and Moscow. The policy of the local authorities can exert a powerful influence over the development of small business, because they own most of the premises and all the land, and have wide tax and other legislative powers. Why Moscow leads in terms of small business development is further analysed as well as the reasons for the significant growth in this sector in St. Petersburg. In the next chapter there is a report on empirical work, which I carried out in St. Petersburg, including the evidence collected on small firms from the organisations which were interviewed and the interviews held with different economic actors. Finally, a separate chapter is dedicated to the science sector and scientific entrepreneurship, as research and development occupies an important place in the St. Petersburg economy. St. Petersburg, together with Moscow, being one of the major centres of scientific innovation in Russia. The arguments covered in the chapter are the policies pursued by the Russian government and the St. Petersburg administration in this field, the development of

science parks in Russia and why scientific entrepreneurship developed so little despite Russia's wealth of expertise. The activities of the science parks and innovation centre of the city are also assessed, in an attempt to understand the contribution provided by these establishments to the creation and development of science firms. The conclusion provides a summary of the main points of the research.

## **SOURCES OF INFORMATION**

The sources of information which have been used for this research are:

- official statistics and unpublished reports edited by Goskomstat
- interviews and questionnaire replies
- conferences and seminars
- local and international press and literature
- Internet
- brochures of organisations active in St. Petersburg.

Documentation for the chapters on Russia and on small business theory was mostly obtained in libraries in Italy and Great Britain. In the last couple of years the Internet has acquired more importance as the information available has increased considerably. Some useful information on St. Petersburg can also be obtained from this source. More specifically, the electronic version of the "*The St. Petersburg Times*", which has been available since 1994 and was one the very first magazines to appear on the Internet, the electronic magazines of the Russian Chamber of Commerce, and other magazines contained in the site dedicated to small business in Moscow have been especially helpful. Since the end of 1998 statistical data on small business can be obtained from the server of the Russian SME Resource Centre and from the SME support server established by the Leontief Center in collaboration with the administration of St. Petersburg. The latter tries to be like a "yellow pages" of all the services available to small businesses. I was given a proposal to write an article which was included in the news section of this server.

In order to write the chapters on St. Petersburg I made ten visits there to do fieldwork, but always for short periods, from one to three weeks. During these visits I met at least fifty people: representatives of science parks, associations of entrepreneurs, foreign firms, research institutes, the Academy of Science, foreign and Russian organisations promoting small business and also university professors, single entrepreneurs and members of the local administration. I have also been several times to Moscow to meet local researchers working in the small business field and the vice-director of the State Committee of the Russian Federation for the Support and the Promotion of Entrepreneurship. He introduced me to a few people working in small business development in the administration of St. Petersburg and the Leningrad region. Qualitative, semi-structured interviews were held with most of the above-mentioned people, while in some cases these were based on the pre-prepared questionnaire. In these past years I have learned the Russian language sufficiently well to allow me to carry out the above-mentioned interviews, and required reading in the local press.

In Russia I also attended several relevant exhibitions and their accompanying seminars, as well as a conference on small business. The EBRD meeting held in St. Petersburg in 1994 gave me the first opportunity to establish some contacts. The exhibition "Small Business 1998" held in March 1998, the first of its kind in St. Petersburg, hosted most of the organisations promoting small business which are active in St. Petersburg and the accompanying seminars gave a panorama of their activities. This exhibition was repeated the following year. The attendance of the public has, however, been scarce. It was attended mostly by representatives of small business organisations rather than entrepreneurs. The exhibition "Innovation", held in June 1998 at which many Russian science parks had stands, the accompanying congress "High technologies. Innovations. Investments-98" and the exhibition "American assistance to Russian entrepreneurship", held in April 1997, were all especially useful. Topics

discussed in seminars were, however, usually too general as most of the speakers described in broad terms the operations of their organisations. The conference “Financial and Institutional Problems of Russian Small Entrepreneurs (regional aspects)” organised in Moscow in April 1997 presented a Tacis-financed survey on small business in selected Russian regions.

In my early visits to St. Petersburg I had to dedicate one-two weeks to organising meetings in the city before departure. Initially, research was carried out to locate organisations and institutions dealing with small business, and a majority of these organisations were contacted, either by fax from Italy or directly by telephone in St. Petersburg. In order to maintain contacts with Russians I wished to meet again in later trips, I spent considerable time prior to each visit assembling useful information for them and trying to establish contacts in Italy on their behalf. The level of response to my faxes from foreign organisations was good though from their Russian counterparts it was very poor. Nevertheless, the majority of Russians agreed to meet me once contacted directly by phone. I managed to have meetings with several of the foreign organisations working in St. Petersburg and a few also agreed to fill in the questionnaire. I am particularly grateful to Ilya Karasev, of the USAID-sponsored organisation TUSRIF, who filled in the questionnaire on the basis of data referring to all the 326 firms he dealt with - a very-time consuming task.

Several interviews were held with the management of three of the four science parks analysed in the research. The fourth was visited during an organised visit for participants of the exhibition “Innovation”. Feedback was also received by carrying out informal discussions with the tenant firms. In particular the vice-director of the science park of the Technical University and his assistant spent many hours with me discussing science parks in St. Petersburg. A project for a seminar for science park directors was also worked out together with the Environment Park in Turin, the realisation of which depends on the obtaining of financing from the

programme Bistro-Tacis. Representatives of the local administration were contacted directly in order to have more detailed information about support programmes for small business and industry and these proved to be very collaborative.

Interviews with entrepreneurs were arranged with the assistance of the local magazine "*Preprinimatel' Peterburga*" and through other people I had met in St. Petersburg. The director and his assistant were also very helpful for the interesting exchange of ideas. Some of the firms could not, however, be contacted any more after the first visit. The arrangement of meetings with Russians was surely facilitated by the fact I was a foreigner and could be a useful vehicle for them to establish contacts with foreign partners or obtain useful information, but this was not always the case. Some agreed to meet me just in order to be useful for my research and I could not find any way to exchange the favour they did for me except with the promise that I would give them a copy of the research once it was completed. A few, instead, turned out to be of little interest for my research as they ended up speaking of how the project they had in mind could be interesting for foreign partners.

St. Petersburg has two main business magazines. Both have a small business section, although this is not included in every issue. The Swedish-owned "*Delovoi Peterburg*" (Business St. Petersburg) comes out three times a week and is one of the few not aligned with the local administration not being financially dependent on its support. The Russian-owned "*Ekonomika i Zhizn'* (recently renamed *Ekonomika i Vremia*): *Sankt Peterburgskii Regional'nyi Vypusk*" (Economy and Life: St. Petersburg Regional Edition) is a weekly publication. There are other two business magazines ("*Delo*" and "*EKO*") edited in St. Petersburg, but these are rarely found in the newsagents and have a very small circulation. In addition, the national daily "*Kommersant' Daily*" carries a local page on business in St. Petersburg three times per week. There is also a magazine entirely dedicated to small business, "*Preprinimatel' Peterburga*" (The

Entrepreneur of St. Petersburg), which comes out once a week; and, although having the administration among its founders, it often takes an independent stance.

The magazine "*Preprinimatel' Peterburga*" was a precious source of information reflecting the attitude and views of the local businessmen community. The other economic magazines published in St. Petersburg have also been useful especially with regard to the economic policy in the city. I have also made use of "*The Socio-Economic Situation in St. Petersburg. A General Overview*" edited on a by-monthly basis by the Leontief Center and the "*Vestnik Administratsii Sankt-Peterburga*" (Bulletin of the Administration of St. Petersburg) published by the Administration of St. Petersburg also on a by-monthly basis. The magazine "*Innovatsii*" has provided information on the science park movement in Russia. Having known personally the editors I was asked to write an article on venture funds which I thought was a good idea in order to spread my name.

Official statistics were obtained from the Goskomstat offices in St. Petersburg. Goskomstat employees were, however, very secretive about the methods utilised to collect data and no useful information on this matter could be obtained from its staff. In Russian libraries other local and national magazines which I could not find in British and Italian libraries have been consulted. I also made use of research on small business in Russia edited by the Leontief Center in St. Petersburg, the Russian Independent Institute of Social and Nationalities Problems and the Institute for Private Sector Development and Strategic Analysis in Moscow. A lot of literature has appeared in the last few years on small business in Russia, but what is often missing is an analysis of data even if it is clear by analysing and comparing data that there are some incongruities. Data analysis has represented a serious problem as it is sometimes difficult to find explanations for these incongruities.

# **1. SMALL BUSINESS: THEORY AND PRACTICE**

## **INTRODUCTION**

The thesis is concerned with the development of small business in St. Petersburg and Russia as a whole since 1989. Small business has played an increasing role in capitalist countries, especially in innovation and in employment generation. It might, therefore, be expected that one aspect of the transition from a socialist to a post-socialist economy would be the development of small business. As an introduction to analysing the post-1989 development of small business in Russia the first section provides a brief assessment of how small business has fared in developed market economies in the last thirty years and the reasons underlying its changing importance in these economies. These can offer an insight as to the reasons why communist economies have not been able to maintain the pace of advanced market economies. This chapter also reviews the major issues raised in small business research (the interpretations of entrepreneurship, personality traits, creation of new enterprises, success strategies). A subsequent section considers how the private sector came into being in the Soviet period, whether traditional small business research can be useful for the Russian case and discusses the theories which can explain why this sector has not fared well in post-Soviet Russia, even though the main sources of market change expected to lead to small business growth were present in Russia. The increasing role of small business in Eastern Europe is also addressed with a focus on the manufacturing sector since manufacturing plays the most important role in economic growth.

### **1.1. THE DEVELOPMENT OF SMALL FIRMS IN THE POST-WAR PERIOD**

The importance of small firms in modern market economies has been reassessed in the last twenty years because there has been a reversal of the long-term industrial trend towards larger units in almost all industrialised

countries. For a long time with the exception of a short period in the 30's, there had been an almost continuous development towards larger units and a higher concentration in the industrial structure.

For this reason until the 1970s the prevailing view was that small firms had a minor and diminishing role to play in the economy (Galbraith, 1956: 7-8; Berger, 1980: 88), because they were considered, as a rule, less competitive than larger establishments. According to Galbraith large firms exploiting economies of scale could perform better than small firms in every economic aspect - productivity, technological progress and job compensation. Servan-Schreiber (1968: 113) warned Europeans to heed the American challenge represented by giant corporations which were unrivalled in terms of dynamism, organisation, innovation and boldness. In order to compete on equal terms with the Americans he advocated the creation of large industrial units of a size similar with their counterparts across the ocean since only giant corporations are in a position to amass the necessary resources for innovation.

Indeed in the 1950s and 1960s the industrial policy of the advanced market economies tended to favour large units of production. It was believed that big firms were better at innovating because of the scale economies existing in research and development (henceforth R&D). Their size meant that they could also reduce the risks associated with R&D by diversifying into several research projects and were better able to sustain the high fixed costs involved. Finally, large firms were considered to be in a better position to exploit the results of their research efforts both because a well-known firm can more easily enter a new market and because synergies with other activities are better developed in large firms (Vossen, 1998: 89).

These opinions have been challenged especially since the 1980s when new evidence has shown the increasing importance of small firms. In the 1970s there was a marked revival of entrepreneurship in advanced market economies, which in the 1980s became more pronounced. New market

niches opened up giving the possibility for small firms to fill them. The absolute number of businesses witnessed a strong surge as did the number of self-employed. The 1985 Economic Report of the President of the United States identified the growth of small business as the engine of the economic surge in the first half of the 1980s in the United States (Acs, 1996: 45). The 1980s were also the period when the economic crisis in the socialist bloc dominated by huge conglomerates became more apparent. They were unable to take advantage of the new technologies. For Porter (1990: 125) innovation and entrepreneurship are nowadays at the heart of national economic advantage. Entrepreneurship contributes to economic growth through the formation of new firms and because of the innovative role it plays in economic life (Wennekers, Thurik and Buis, 1997: 21). High firm birth was found to be an important prerequisite, even if not a unique condition for economic growth. Studies on the correlation between start-ups and economic growth have demonstrated that while entrepreneurial activity is not a sufficient condition for economic development, economic development will not occur without entrepreneurial activity (Binks and Vale, 1990: 49; Reynolds, 1996: 11).

The declining importance of large corporations is attributed to the changing economic environment in many parts of the world, and specially in the industrialised countries. Piore and Sabel (1984: 183) have argued that the economic crisis of the 1970s was a consequence of the instability of markets, the antithesis of the model of industrial development based on mass production. The economic stability that characterised the world economy up to the early 70's, more or less until the end of the Bretton-Woods agreement, was lost. Stable markets were necessary to allow the exploitation of mass production technologies used by large corporations. For Porter (1980) the shift from standardised goods usually provided by large firms towards more differentiated products and services which small firms are more capable of providing was a result of the rise in incomes. A much stronger demand evolved for higher quality and more differentiated services and products. The average life of a product - the product life cycle -

shortened considerably. This favoured small firms which tend to be more responsive to market needs and more adaptable to change. Carlsson (1996: 68-84) explains the shift to smaller firms as being due to the influence of two factors. The first is the fundamental changes which have occurred in the world economy since the 1970s: the intensification of global competition, the increase in the degree of uncertainty and the growth in market fragmentation. The second is the change in the character of technological progress. The cost of technology changed. With the advent of the micro-computer, and micro-electronics, the small firm could easily purchase a computer. It is believed that the appearance of computer-based technology has allowed small companies to improve quality and productivity in comparison to the standardised mass technologies that had predominated earlier, thus opening up considerable entrepreneurial opportunities (D'Andrea Tyson, Petrin and Rogers, 1994: 181). Scale economies are believed to have fallen in certain key industrial sectors (Karlsson, Johannisson and Storey, 1993: 6).

We can, therefore, say that there has been a shift in consumer demand and hence in basic business structures, and in some ways, this has favoured small firms. The previously held view that big is better for innovation was also reassessed. Link and Rees (1990: 30) came to the conclusion that, although large firms are more active in university-based research, small firms are more able to exploit their links with universities to generate innovations. They argue that the bureaucratic structure of large firms tends to obstruct innovative activity and slows down the process of launching new inventions in the market, while for Cohen and Klepper (1992: 793) even if large firms produce fewer innovations per dollar spent on R&D their innovations are on average of a higher quality. In effect, when innovation and patents filed are monitored being small seems to be an advantage. Acs and Audretsch (1987: 569) found the average innovation rate of small firms (calculated on the number of employees) to be 43% higher than that of large firms in 1982. They however, remarked that this does not imply that small firms are more innovative than larger ones. In their opinion, small and large

firms are good at different types of innovation. In certain industries the small size represents an advantage in developing innovation. Small firms are better where economies of scale are not important and where they can exploit their flexibility and proximity to market demand. Large firms perform better in innovations which require economies of scale and a large team of specialists. For example, in computers and process control instruments small firms have demonstrated to be more innovative, while the opposite was true in the pharmaceutical preparation and photographic equipment industries (Acs, 1996: 31).

The shift in economic activity from large to small firms has been greater in manufacturing than in services or finance. In the United States between 1976 and 1986 the share of employment of small firms increased in industry, but decreased in the other sectors and an analogous trend has been observed in most advanced market economies (Acs, 1996: 46). Over the period 1958-1968 in the United Kingdom the proportion of employment in industrial firms with up to 200 employees went down from 24% in 1958 to 20.8% in 1968, but subsequently increased to 26.5% by 1983, while the productivity of this category of firms in terms of innovations has constantly increased since 1958 and in 1983 was 60% more than in 1958 (Monck and others, 1988: 42). Data for the years 1988-1993, referring to the EEC countries, point to a continuance of the trend towards smallness. The growth in employment has been particularly vigorous in micro enterprises, followed by small enterprises, while medium firms have lost workers and employment in large enterprises has remained on the same level (ENSR, 1994: 12). There are, however, considerable differences regarding the importance of small and medium firms in the industrial world. Some countries have performed much better than others and even within the same country there are regions or sectors which have performed much better than others. Contributions of small and medium enterprises to GDP range from 34.9% in Germany (1988) to 61.8% in France (1990) (OECD, 1998a: 20).

In 1988 employment in small firms (with up to 100 employees) accounted for 45-60% of the total manufacturing employment in Italy, France and Japan, but only 18-28% in the United Kingdom, Germany, the United States and Sweden (Carlsson, 1996: 66) and regarding Germany and Sweden there is no indication that these differences are narrowing. In Italy, which already in the 1950s had one of the highest shares of employment in small manufacturing firms the trend has been upwards ever since, except for a very slight decrease in the 1960s. In Germany, which had one of the lowest shares in the 1950s, the trend was downwards till the 1970s and has subsequently stabilised. The United States, which had a share equivalent to Germany at the beginning of the 1950s (around 25%) witnessed an increase in the 1970s which became more pronounced in the 1980s, so that at the end of the 1980s its share was one and half times higher than the German one. Sweden represents an unique case since the shift to smallness has not occurred. Employment in small manufacturing firms crumbled in the 1970s and had a negligible growth in the 1980s (Carlsson, 1996: 66). This might partly be due to the fact that it had a relatively high share in the 1950s (around 40%) - much higher than that of the United States, the United Kingdom or Germany.

The increase in importance of small business has prompted more attention to entrepreneurship from policy makers, while in the past new business creation was thought to be rather unimportant generating mainly low value and transitory jobs. The emphasis was on attracting foreign investments and developing existing businesses (Deakins, Jennings and Mason, 1997: XII). The promotion of small business is justified by the externalities that this has on the economy: increased market competition, the considerable contribution to innovation activity and the creation of new jobs. Small firms are also credited with creating much of the market turbulence that not only increases competition, but also provides a mechanism for regeneration (Beesley and Hamilton, 1984: 217-231). Four major areas of market failures are usually mentioned to justify the state's small firm policy (Stanworth and Gray, 1991: 18):

- the power of monopolies which impedes new entries into the market.
- the higher costs for small businesses in collecting and analysing information on market opportunities, sources of finance, etc.
- the fact that small firms are less able to diversify the risks and sustain the high initial costs incurred in the development of new products and innovation.
- the difficulty in obtaining finance.

On the effects of government policies in this area there is, however, ample debate. It is still not clear whether public policy can influence the factors which affect small business dynamics. The policies carried out in the 1980s in the United Kingdom were estimated by Storey (1994: 77) to have had only a relatively marginal impact, while the most powerful factors in his opinion were the structural changes which occurred in the economy, the high level of aggregate demand and the access to capital. This seems to confirm the view that given business opportunities, companies will emerge to take advantage of them. The role of the government would be simply to create an environment in which small business could develop, while refraining from a specific policy to promote entrepreneurship. However, for Eastern Europe where the market structures are emerging after decades of centralised economy there is a general consensus that a support structure is of fundamental importance (Brunner, 1993: 510; Gibb, 1993: 464; Arzeni, 1996: 56). Brunner is convinced that government agencies have a vital role in establishing an effective network of support structures in the country.

## **1.2. MAIN ISSUES IN SMALL BUSINESS RESEARCH**

The literature on entrepreneurship can be divided into 5 categories (Bull and Willard, 1993: 184) which will be analysed in the following pages:

- the debate on the definition of the word entrepreneur
- the study of the psychological traits of entrepreneurs
- the study of the influence of environmental factors on entrepreneurial actions

- the study of the creation of new enterprises
- the success strategies.

### **1.2.1. THE DEBATE ON THE MEANING OF THE WORDS ENTREPRENEUR AND ENTREPRENEURSHIP**

A common definition of entrepreneurship and entrepreneur does not exist despite the fact that these terms have existed for two centuries. The definition, characteristics and role of the entrepreneur have been interpreted in different ways by countless scholars. In neo-classical economic theory there is little room for entrepreneurs. The logic of rational choice and perfect information means that the economy is characterised by an equality of price with marginal cost and therefore economic profits are absent. No single supplier or buyer can affect market functioning. This leaves no space for the initiative of the individual. However, this theory has not been found satisfactory by many scholars. Most of the theories on entrepreneurs assume that entrepreneurs recognise and act upon market opportunities, whose existence implies a state of market disequilibrium. This state of disequilibrium allows the exploiters of these opportunities to produce at a lower cost, while selling at the current price and thus earning a profit. It is impossible to list all definitions given in the economic literature. However, to summarise the different definitions, listed below are thirteen different roles which have been identified by Wennekers, Thurik and Buis (1997: 17) regarding entrepreneurs in the economic literature:

1. the person who assumes the risk associated with uncertainty (Knight)
2. the supplier of financial capital
3. an innovator (Schumpeter)
4. a decision maker
5. an industrial leader
6. a manager or a superintendent
7. an organiser and co-ordinator of economic resources (Babson)
8. the owner of an enterprise (Hawley)
9. an employer of factors of production

10.a contractor

11.an arbitrageur (the Austrian school)

12.an allocator of resources among alternative uses (Hawley)

13.the person who realises a start-up of a new business (Gartner and Low and McMillan).

In general, each view encompasses some aspects of what entrepreneurship is. Some can be considered complementary, rather than competitive. The broadest definition encompasses any individual economic activity, even self-employment on a part-time basis and associates entrepreneurship also with existing enterprises. A first restriction can be to consider only full-time self-employment. A further restriction is to identify with this term only firms which create jobs for others. This definition can exclude family production firms and service activities such as restaurants. More restricted interpretations refer only to major changes in productive or economic activity as entrepreneurial. Another criterion refers to the growth rate: only enterprises with high growth rates can be considered entrepreneurial. In this section I distinguish between the main definitions which have been provided so far.

The definition of the entrepreneur as an innovator is linked to Schumpeter who identified entrepreneurship as “carrying out new combinations” (Schumpeter, 1934: 74). The entrepreneur takes advantage of technological changes to create new combinations of resources. It follows from this that the rate of entrepreneurship is determined by rates of technological change. Innovation and entrepreneurship have been inter-linked since Schumpeter. In his opinion (Schumpeter, 1947: 132) “the function of an entrepreneur is to reform or revolutionise the pattern of production by exploiting an invention or, more generally, an untried technological possibility for producing a new commodity or producing an old one in a new way, by opening up a new source of supply of materials or a new outlet for products, or by reorganising an industry and so on”, but as the entrepreneurial function is performed he ceases to be considered an entrepreneur. His

definition is, therefore, quite narrow as the entrepreneur “loses his character as soon as he has built up his business”. In his conception the entrepreneur has a key role in the economy since he is the cause of economic development. The innovations produced by entrepreneurs are, if successful, a source of extraordinary profits for a temporary period of time. When imitators finally reduce profits margins this gives rise to reorganisation of production and the closure of inefficient, non-innovating firms. This process of creative destruction is, in the opinion of Schumpeter, the cause of the cyclical fluctuations in the economy.

Other theorists viewed the entrepreneur as somebody who takes risks and reduces uncertainty rather than as a creator of innovation. The entrepreneur is an individual who makes decisions in conditions of uncertainty. This condition of uncertainty and change makes the entrepreneur a key actor in the economy. Knight (as quoted by Low and MacMillan, 1988: 140) defined entrepreneurship as the ability to predict the future successfully. Similarly Hawley (1893: 478) considered the entrepreneur to be the individual who owns the output of an organisation and, therefore, endures the uncertainty of the output. In his conception ownership rights are a necessary condition for engaging in entrepreneurial activity since they allow the entrepreneur to make decisions regarding the co-ordination of resources. An opposite view is held by Babson (as quoted by Timmons, 1990: 5) who sees entrepreneurship as “the process of creating or seizing an opportunity and pursuing it regardless of the resources currently controlled”.

Kirzner (1982: 273) of the Austrian school considered the entrepreneur to be the individual who arbitrages imperfect information. He is more alert than the others in perceiving profit opportunities. His best known case for illustrating alertness is that of the arbitrageur who finds the opportunity to buy at low prices and resell at higher prices. For the Austrian school opportunities for entrepreneurial activity crop up continuously so that new combinations of resources can be arranged to fill market gaps and monopoly profits can be reaped temporarily.

For the Austrians an entrepreneur is the founder of a new firm regardless of the fact that it is innovative or not, while for Schumpeter he is somebody who transforms inventions and ideas into economically viable entities whether or not in the course of doing so he creates or operates a firm. For the latter the entrepreneur causes change of factor allocation, while for the former he responds to a requirement for that reallocation. Recognising these opportunities entrepreneurs move the market toward equilibrium (Kirzner 1982: 273-4; Mises 1949: 295) according to the Austrian school, while Schumpeter saw them as disequilibrators.

Another category of entrepreneurs is described by Leibenstein as somebody causing improvements of a gradual nature to existing products and processes. They are the agent of change themselves rather than responding to market signals, but in a more gradual manner compared with Schumpeter. He says that firms have a certain degree of inefficiency called X-inefficiency in the utilisation of resources inside the firm. The greater the X-inefficiency within an industry the greater the opportunities for entrepreneurs. In his opinion entrepreneurship is the ability to work smarter and harder than the competitors as firms do not necessarily fully exploit their production capacity (Leibenstein, 1978).

Another definition has been given by Cole (as quoted by Low and MacMillan, 1988: 140) who interpreted entrepreneurship as meaning purposeful activity to initiate, maintain, and develop a profit-oriented business, while Gartner (1985: 697) and Low and MacMillan (1988: 141) defined entrepreneurship as the creation of new organisations and new enterprises respectively. In the opinion of the latter entrepreneurship research must try to explain and facilitate the role of new enterprises in furthering economic progress. A larger and more detailed definition of entrepreneurship is proposed by Wennekers, Thurik and Buis (1997: 54) who describe it as: “the ability and willingness of individuals, both on their own and within organisations to:

- perceive and create new economic opportunities (new products, new production methods, new organisational schemes and new product-market combinations);
- introduce their ideas in the market, in the face of uncertainty and other obstacles, by making decisions on location, form and the use of resources and institutions;
- compete with others for a share of the market.”

Their definition encompasses not only persons who start a small firm, but also corporate entrepreneurs working in large firms. Similarly Drucker (1985: 20) considers entrepreneurship not confined to new business but connected with the nature of business activity. An existing enterprise can be entrepreneurial by creating something new.

In view of the great number of interpretations of the word entrepreneur, it is necessary to define the meaning used in my research. Entrepreneurs here are defined as creators of new firms. Special attention has been paid to innovation because of the importance of science in the St. Petersburg’s economy.

### **1.2.2. PERSONALITY TRAITS AND ENVIRONMENTAL FACTORS**

There is ample literature on the entrepreneurial personality. Case studies of entrepreneurs have tried to identify certain traits which distinguish them from the rest of the population. The simplest theory suggests that it is the possession by individuals of certain traits which predispose them towards enterprising behaviour: powerful personalities, a strong need for achievement, the belief that they can determine their fate through their own behaviour (locus of control), a strong inclination towards risk taking. Other motivations for becoming an entrepreneur are thought to be the desire to be autonomous, have personal freedom (which as an employee is impossible to achieve), self-fulfilment, money and need for power (Huuskonen, 1993: 44-46).

Risk bearing or risk taking behaviour is considered a major aspect of entrepreneurship (Carland and others, 1984; Casson, 1995: 105). There have been a number of empirical studies on risk taking, but the results are frequently contradictory. Entrepreneurs have been often regarded as high risk takers, but more recent research has challenged this vision of entrepreneurs, saying that they resemble more or less the general population (Low and MacMillan, 1988: 147; Brockhaus, 1982: 47). According to Low and MacMillan (1988: 147) the entrepreneur can be seen as a moderate risk taker who has the capacity to minimise the risk in situations that others might see as highly risky, while the Durham Business School describes him as a calculated risk taker who assesses situations thoroughly and does not pursue options which he considers to have a small probability of success (Bridge, O'Neill and Cromie, 1998: 44). Equally contradictory is the evidence that there is a difference between entrepreneurs and other compared groups regarding the need for achievement and locus of control (Brockhaus 1982: 43-44; Gartner, 1985: 699; Sexton and Bowman, 1985: 131-132). In fact, it is difficult to isolate some traits characterising the entrepreneurial population because some characteristics normally associated with entrepreneurs, like high need for achievement, could also be valid for successful managers, professionals and salespeople and because, as Gartner (as quoted by Low and MacMillan, 1988: 148) observed, there is probably as much difference among entrepreneurs as between entrepreneurs and non-entrepreneurs.

Indeed, as emphasised by several authors there are completely different types of entrepreneurs depending on the sector in within they are involved. Using personality traits, researchers have tried to identify different types of entrepreneurs. The literature on entrepreneurial typologies mainly focuses on two typologies: opportunists and craftsmen (Chandler, 1983: 55; Davidsson, 1988: 101). Opportunists are, for example, the founders of new-technology-based firms, who are usually between thirty and forty years old, have at least one degree, are career oriented and achievement motivated.

Craftsmen are, instead, as a norm single owner-managers, poorly educated with little or no managerial experience and little inclination towards taking risks. Their businesses tend to be less adaptable to change and to have lower growth rates, usually because they have no ambition to make them larger. They mainly carry out entrepreneurial activity in order to achieve independence and autonomy, while giving less importance to earnings. These are the most common typologies utilised, but other authors have distinguished more than two types. Dunkelberg and Cooper (1982: 4-6) identify the “craftsmen oriented”, the “growth oriented” and the “independence oriented”, while Stanworth and Curran (1973: 97-99) identify three categories, the first of which corresponds to the craftsmen. The other two are:

- the classical entrepreneur who starts a business attracted by the possibility of making large earnings without or with an element of growth.
- the managerial entrepreneur who sees entrepreneurial activity as a method to earn a good income and reach a higher social status. He is interested in seeking recognition for managerial excellence.

Another area of the research on personality traits has sought to find out whether there is a correlation between the personality traits associated with entrepreneurs and the success of their firms. Some authors have argued that personality factors are not sufficient for entrepreneurial success, but that entrepreneurial success is to a good deal correlated with experience in start-ups and/or in a relevant line of business. The importance of experience in the relevant field is corroborated by several studies (Roure and Maidique, 1986: 304; Cooper and Bruno, 1977: 22), while evidence that certain personality traits predispose people to entrepreneurial success is mixed. Some studies found a positive correlation between certain personality traits and firm survival while others did not find any (Brockhaus, 1982: 45; Cooper and Gascon: 1992: 309; Miner, Smith and Bracker, 1989: 559).

Given the difficulty in finding common ground recently scholars have come to judge the search for entrepreneurial traits as rather unproductive<sup>1</sup> (Ronstadt, Peterson and Vesper, 1986: XIV). In addition, the reliability of these studies has been put in doubt by Low and MacMillan (1988: 148) on the grounds that samples are rarely representative of the entrepreneurial population due to a bias towards successful entrepreneurs, and that the observed entrepreneurial traits may be the product of entrepreneurial experience. Although attempts to stereotype entrepreneurs have been largely discredited it has been recognised that entrepreneurial personalities have important influences on the organisations they create (Schein, 1983).

While the desire to create a business was assumed to be inherent in the individual in the earlier studies, further research has pointed to the importance of experience and culture in addition to personality and motivation (Birley, 1989: 9-10). One of the most comprehensive frameworks which takes into account the various factors influencing entrepreneurs' decisions has been provided by Cooper (1981: 40). These factors have been divided into three groups:

- the entrepreneur, including the many aspects of his background which affect his motivation, his perceptions, and his skills and knowledge.
- the organisation for which the entrepreneur had previously been working, whose characteristics influence the location and the nature of new firms, as well as the likelihood of spin-offs.
- various environmental factors external to the individual and his organisation, which make the climate more or less favourable to the starting of a new firm.

Liles (1981: 41-43) argues that personality factors may be necessary conditions for engaging in entrepreneurial activity, but they are not sufficient. Whether individuals finally feel capable or not of starting a business depends on work experience matured, career stage and the perceived risks which are strongly correlated with family and domestic

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<sup>1</sup> This conclusion was based on a survey of researchers at the 1986 Babson College

responsibilities. For this reason the life period which presents the greatest opportunities for entrepreneurial activity is between twenty-five and thirty-five years. The background of most entrepreneurs tends to be a family firm, the existence of entrepreneurs in the family (Du Brin, 1984) and/or work experience in small businesses. In almost all the studies carried out on the backgrounds of entrepreneurs it was found that their father or a close relative was also an entrepreneur. The experience of working in a small business or the example of close relatives helps to create in the person a favourable attitude towards entrepreneurship. Attitudes such as the personal conception of the risk involved in starting an activity are assumed to be influenced by the attitude of the group with which one identifies (Huuskonen, 1993: 45).

Bearse (1982: 92) also considers the culture of the community to be important for entrepreneurship. Some cultures are believed to be more entrepreneurial than others. McClelland (1961: 64 and 105) associates entrepreneurial activity and as a consequence economic growth with the frequency of achievement themes in the local culture. He, therefore, propounds that need for achievement is culturally acquired. He came to the conclusion on the basis of historical and cross-cultural studies that economic growth was correlated with the frequency with which achievement themes appeared in popular stories and literature especially those meant to be read by children. His findings point out that a high level of achievement imagery in children stories would translate into a period of economic growth in about three decades time. McClelland demonstrated the importance of achievement theory by comparing two groups: one which had received achievement motivation education and another which had not received it. The first produced a higher supply of entrepreneurs than the second group.

The importance of the culture of the community is emphasised by the existence of areas with a high level of entrepreneurship and areas with very

little activity in this field. Research undertaken for Scottish enterprise concerning the low participation rates in entrepreneurship showed that one of the factors contributing to low entrepreneurial activity was the “dependency culture” due to the historical dependence of the population on a limited number of large employers (Deakins, 1996: 15). Wiener (1981: 131) implies that the weaker economic growth in Great Britain compared with the other advanced countries can be at least partially emphasised by the different attitude towards entrepreneurship. While in the USA Henry Ford was a folk hero, in Great Britain successful entrepreneurs stirred little emotion. In the opinion of Birch (1987: 99-104) small business has a weaker role in Europe compared with the United States due to over-regulation and to the fact that entrepreneurs have a lower rank in society than employees in large organisations and in government, while in the United States the dislike of authority plus the pragmatism of the society represents a favourable environment for enterprise creation.

The entrepreneurial climate may, however, undergo substantial changes over time. McClelland’s (1975) research on the need for achievement indicated large variations of this characteristic in societies over periods longer than ten years. A major shift in entrepreneurial values seems to have taken place in the United States in the early 1970s. This could be one of the reasons for the spurt in entrepreneurial activity taking place from the 1970s onwards. The annual survey conducted on college freshmen by the UCLA<sup>2</sup> found a large variation of response between the period 1966-1972 and 1972-1990 regarding the questions on the importance “being successful in their own business” and “being well-off financially”, while during the period 1972-1990 variations were much smaller in comparison with the previous period (Gartner and Shane, 1995: 290). The role of personality and culture in the formulation of entrepreneurship will be discussed in the Russian context in a subsequent section of this chapter.

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### **1.2.3. THE STUDY OF THE CREATION OF NEW ENTERPRISES**

While the previous approach looks at the influence of factors such as work experience, culture, motivation and personality on the creation of new firms other approaches look at the market conditions which favour new firm creation.

The industrial organisation approach looks at the effects that the structure of industry exerts in attracting and deterring entry. For industrial economists a supply of entrants is assumed to be given. Their interest is in which sector and under which circumstances entry takes place, which are the characteristics of market structure which facilitate or impede entry and the impact that entry has upon prices. Labour market economists, instead, analyse the creation of new enterprises as a decision exercised by the individual in the context of the labour market. They evaluate the relative importance of push-pull factors.

In general the factors influencing the creation of new enterprises are divided into two categories: push and pull. The first refers to environmental imperatives which force people to become entrepreneurs involuntarily such as the lack of alternative employment opportunities, while the latter indicate changes in industry such as a demand for additional goods and services, which create new market opportunities leading to higher levels of entrepreneurship.

In theory the greater the rate of industry change, the more opportunities are created in an industry and the greater the rate of entrepreneurship within the industry (Dean, Mayer and DeCastro, 1993: 53). Knight, Dowling and Brown (1987: 152) studying the automobile, semiconductor, vacuum tube and airline industries came to the conclusion that the creation of new firms is influenced by a variety of factors such as new technology, new markets, deregulation or shifts in government regulation, life cycles and

environmental conditions, while Dean, Meyer and DeCastro (1993: 52) indicated 5 possible sources of market change:

- increase in demand
- modification in demand
- technology development
- new sources of supply
- political/regulatory change.

The effects of an increase in demand results in the creation of opportunities to capture the new demand. At the same time new entrants are also attracted by increased profit expectations as the additional capacity will affect prices less. The second type of change - a modification of products desired by consumers - creates new niches. It is commonly assumed that the larger the change in demand the greater the opportunities. Technological development is divided into product and process innovation. Product innovation can result in new niches or new industries while process innovation leads to more efficient methods of production making it possible to produce a given product at lower costs. A reduction in costs may also be achieved through the utilisation of new sources of supply. Political/regulatory change can be of minor importance (i.e. concession of higher or lower tax breaks for specific processes) or major significance, as in the case of de-monopolisation of an industry.

The outcome of these changes can be either the creation of new companies to exploit these opportunities, or a move by existing firms, or neither if no firms take advantage of these opportunities. The extent to which opportunities will be exploited depends on the relative strength of the constraints on existing firms due to their organisational inertia, and on the creation of new firms. The latter are called barriers to entry. Existing firms tend to be inertial in responding to change as the bureaucratic organisation that these firms usually have is not conducive to change. Stinchcombe (1965: 155) said enterprises have a tendency to become institutionalised and that the basic structures of organisations remain relatively stable in the long

run. Barriers to entry to new firms are mainly represented by plant location, product differentiation, economies of scale and excess capacity (Dean, Meyer and DeCastro, 1993: 54). Other entry barriers can be government regulation, access to distribution channels and proprietary knowledge (Dean and Meyer, 1996: 114). Product differentiation has been described by Bain (1956: 216) as the strongest barrier to entry. It can be the result of the popularity of brand names, company reputation and control of favoured distribution channels. Advertising, which is considered to be an indicator of product differentiation, is believed to be a barrier to entry, the impact of which is in line with its intensity. The existence of significant economies of scale may entail that few potential entrants can find the necessary capital to produce at the minimum efficient scale. The result can be a highly concentrated market where the participants collude to thwart the activities of new-firm entrants (Dean, Meyer and DeCastro, 1993: 55). Excess capacity within an industry may deter entry because of the effects that a new entrant will have on price and profitability.

There are several studies analysing the relative strengths of these pull-push factors and the importance of the barriers to entry, but according to Audretsch (1993: 41) the major weakness of most studies is that they do not take into consideration new firm formation, but focus on net entry the difference between firm births and deaths or, if they focus on new entries, they do not differentiate new firm start-ups from all entrants. It is clear that a situation in which net entry is very small compared with the total number of entities can be the result of a large number of entries and exits. Dean and Meyer (1996: 123) – one of the few who focus on new firm creation –, analysing a large sample of U.S. manufacturing industries in the 1970s, found that capital requirements and industry concentration were negatively correlated to the formation of new enterprises, while R&D intensity, niche dynamism and sales growth had a powerful effect on new firm creation. Little evidence was found that advertising and excess capacity represent a barrier to entry. According to their findings the positive opportunities represented by R&D intensity turned out to be stronger than the constraints

represented by the capital requirement barrier. This supports the theory that the greater the changes the greater the opportunities and therefore the creation of new ventures. Two variables such as vertical integration and failure to invest in new capital which are usually associated with inertial behaviour of existing firms and therefore higher rates of new firm creation were found to have had this effect. Orr (1974: 65) came to similar conclusions regarding the impact of the various barriers to entry except for advertisement spending which according to his findings turned out to represent a strong barrier to entry, while on this point Vivarelli (1991: 222) agrees with Dean and Meyer. Audretsch (1993: 49) in another study did not find evidence of push factors in the creation of new manufacturing firms in the United States, which was found to be largely related to expectations of increased profitability. Daen and Meyer (1996: 128) also came to the conclusion that demand factors are the prime determinants of new firm formation in manufacturing industries, rather than push factors.

However, factors which are found to be of little significance in one country may be much more important in another and the same can be said of different industrial sectors (Karlsson, Johannisson and Storey, 1993: 14). Hence, rates of formation of new firms may vary considerably from one sector to another, from one period to another and from one country or region to another (Storey, 1994: 76)

In addition to the above-mentioned factors two more conditions can be identified as having a strong effect on the creation of new firms:

- resource availability
- networks.

The first mainly refers to the availability of different types of input resources: premises, finance and human. Finance, especially, is commonly regarded as critical for small business development (Gibb, 1993: 46). A major stumbling block for the concession of loans to small businesses is the

request for collateral that many firms are unable to provide and the low inclination of bank managers to take risks.

Regarding the second point, the efficacy of networks is well documented in entrepreneurship literature. In theory, both the formal (banks, accountants, lawyers, associations) and informal networks (family, friends, business) are believed to influence the nature of the firm substantially (Birley, 1985: 107), but while there is strong evidence regarding the second point, on the first point the evidence is weaker. Birley (1985: 113-114) in her study of start-ups in an American town found that informal contacts, mainly in the form of business contacts, are seen to be the most helpful in assembling the elements of the business. Family and friends are the most useful in local issues like the search for premises and employees, while formal sources are much less utilised. Only the bank was mentioned with regularity. According to Aldrich and Zimmer (1986: 20) social networks not only influence the decisions of the single entrepreneur, but also the total supply. Similarly Vesper (as quoted by Birley, 1985: 105) found that contacts are usually the main source of new firm ideas. This probably explains why areas with many small manufacturing firms usually have high rates of new manufacturing firm formation (Storey, 1994: 71). MacMillan (1983: 10-12) goes as far as to say that building contacts and networks is one of the most important factors affecting the success of any firm. The existence of networks of firms characterised by regular contacts and co-operation among themselves is thought to be one of the best ways to solve their problems. Different kinds of networks may originate among firms. A network can be horizontal - made up of similar firms who might share the R&D burden, the costs of expensive equipment, or take part in common projects - or it can be vertical, consisting of firms not necessarily of the same sector which, for example, carry out complementary activities in the development of a new product. A third kind of network is the knowledge network, aimed at solving common problems or exchanging market information (Arzeni and Pellegrini, 1997: 28).

The importance of mutual contact and collaboration is underlined by the development of industrial districts which are conglomerations or networks of many hundreds, sometimes thousands, of small firms in one particular industrial sector, in one industry, where these small firms concentrate in particular activities. In the opinion of Bianchi (1992: 100-101) the Italian model of industrial districts would be appropriate for the reconstruction of industrial sectors in Eastern Europe. These are characterised by extensive inter-firm division of labour, strong productive specialisation, frequent co-operation and consultation between firms. Similarly, Silicon Valley continues to be a centre of innovation partly due to the fact that through inter-firm networks it is possible to spread the expenses and risks involved in developing new technologies and foster reciprocal innovation among specialist firms (Saxenian, 1991: 279). While the vertically integrated model of computer production dominated in the post-war period, in Silicon Valley nowadays firms are able to cope with the rise in costs of product development and the rapid technological change by remaining highly focused on their core business, facilitated by the possibility of relying on a network of suppliers. Problems regarding the development of new products are solved through collaboration among firms and their suppliers. According to Saxenian (1991: 290) “technical expertise in Silicon Valley today is spread across hundreds of specialist enterprises which continue to develop independent capabilities while simultaneously learning from one another”.

#### **1.2.4. SUCCESS STRATEGIES**

Two theories are predominant in analysing the behaviour of firms: the strategic adaptation perspective and the population ecology perspective. The strategic adaptation perspective puts at the centre of its focus the capability of the entrepreneur to influence the nature of an organisation’s activity and its results. The success of individual entrepreneurs is, therefore, correlated with their decisions: the ability of the entrepreneur to identify opportunities, develop strategies, assemble resources and take initiatives. The focus of this perspective is the detection of the policies and strategies for the

development of business and their ensuing translation into managerial action. A key success factor is believed by some researchers to be how quickly the entrepreneur can adapt and learn from the experience of dealing with his environment (University of Glasgow, 1983: 12). Although there is among the followers of the strategic adaptation perspective a wide variation in opinions (Timmons, 1982: 132) there are some recurrent themes that are considered to be the basis for entrepreneurial success: the importance of an entrepreneur with the capacity to lead, building a team with complementary skills, and a well made business plan.

While this theory was widely accepted in the past, the population ecology perspective recently has challenged some of its assumptions. This relatively new approach considers environmental selection procedures to be the most powerful determining factor in the survival of business organisations (Low and MacMillan, 1988: 142). This perspective views inertia as the dominant organisational characteristic and criticises the strategic adaptation school for overemphasising the capacity of an organisation to adapt to a changing environment. In their conception organisations which are well-adapted to their environment survive, while those which are less so tend to perish. The environment is, therefore, all important and there is little the entrepreneur can do. Some subsequent interpretations of this approach have conceded that the organisation can learn from experience, but still attribute a dominant role to the environment. As the focus of this theory is premised on the entire population of firms, it does not provide any practical advice for business executives. It tries to forecast the trend in industries on the basis of historical data sets. This theory has, however, been criticised for having little success in doing so. According to Bygrave (1993: 260) it has not been able to predict future births and closures in any industry. Its practical use in explaining economic changes seems therefore to be limited.

### **1.3. THE PRIVATE SECTOR IN THE LATER PERIOD OF THE SOVIET UNION**

Liberalisation of private economic activity was initiated by the law on individual labour activity adopted in 1986. This law was enacted in order to legalise family businesses, mainly in the service sector, but it had little real impact. A total of 168,100 people had exploited this opportunity by spring 1988. The only kind of businesses allowed were restaurants, dressmaking and auto repair. The categories were, however, progressively enlarged during the following years.

The next step was the law on co-operatives approved in 1987. This law was aimed at students, housewives and pensioners in the field of consumer goods production and consumer services<sup>3</sup>. In theory, people who had employment could work in co-operatives only in their free time, as co-operatives were not expected to lure away workers from their occupations in state firms. According to this law, common property rights were to be given to people sharing the same work obligations, while the hiring of employees was not contemplated, but the law was exploited by a much wider group of people in a much wider sphere (Chepurenko, Avilova and Pripisnov, 1995: 11). Already in 1987 co-operatives working outside the sphere of activity sanctioned by the law were appearing in the Soviet Union.

The aim of the law was to exploit the non-utilised resources in the Soviet system, especially to increase the provision of consumer goods which were in short supply in the Soviet Union, rather than being a first step towards a progressive liberalisation of economic activity. Co-operatives were still envisaged as an integral part of the socialist system. However, progressive liberalisation took place in the following years. While in the first period co-operatives were permitted as a part of the existing system, from 1990 onwards they became part of the drive towards the market. Some restrictions were removed as early as 1988, when co-operatives were

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<sup>3</sup> For example: hair-dressing, dry-cleaning, household and appliance repair services.

allowed to engage in any economic sphere. In the same year the law on enterprises came into force, allowing greater freedom to state managers. On 1 January 1988, state enterprises became subject to some of the same market considerations that applied to private enterprises: profits, job performance, and decentralisation. Production targets were replaced with state orders, which were planned to cover less than half the production capacity, but still represented 75% of total output in 1990 (IMF, WB, OECD and EBRD, 1991, vol.2: 17). The law on lease holding in 1989 opened the way for the purchase of state property; and by the decree of the USSR (no. 790 dated 8 August 1990) "On Measures for the Creation and Development of Small Enterprises", both individual and legal entities were allowed to start small enterprises and employ labour (with limitations) in all sectors of the economy. In 1991 the creation of companies with limited liability was also permitted (law "On Enterprise and Entrepreneurial Activity"). An effect of these laws was the creation of small spin-offs from state enterprises, as private firms enjoyed much more freedom of price and wage formation and less administrative control over their activities. Some spin-offs served to transfer funds illegally from state firms to private businesses owned by the management of state companies (Gibb, 1995: 3). Spontaneous privatisation was often carried out in a semi-legal manner and abuses were common. Managers and workers utilised state funds to set up new private ventures. State managers would lease at a price of their choice the equipment of the enterprise they managed to a co-operative that they helped set up. If officials in higher echelons of power were responsible for controlling the specific enterprise activity, they were brought into the co-operative. A very easy way to make money was exploiting the price differences between the state and private sectors. As the setting of free prices was permitted in the non-state sector, while fixed prices were maintained in the state sector, a two-tier economy began to emerge. In October 1989 the Supreme Soviet forbade co-operatives from buying state goods with the purpose of reselling them and allowed local soviets to fix maximum prices for co-operative products, but these rules were relaxed in the spring of 1990.

State policy towards co-operatives was ambivalent, characterised by forward and backward steps, due to the suspicion they aroused in large segments of the ruling party. Initially they were conceded a lower rate of taxation compared with state firms, but in the last quarter of 1988 taxes were raised, while since 1991 they have been taxed at the same rate as state firms. The law on co-operatives gave ample powers to local bodies which were charged with issuing licences necessary to carry out any activity. As the law stated what was allowed, implying that the rest was forbidden, these bodies had ample room for discretion. Local bodies often used their licensing power to restrict the number of workers in co-operatives, frequently establishing a regional maximum number of employees and refusing to issue licences. The frequent abuses committed did not help. Co-operatives were accused of diverting supplies from the official channels and exploiting scarcities in order to charge very high prices. Their activity was deemed by many as the cause of the increasing shortages of goods, although, ironically, these shortages had been the very reason why they were sanctioned in the first place. They were also accused of breaching the socialist principle of full employment by making some workers redundant. In spite of the fact that they were intended to employ pensioners, housewives and students, they attracted skilled workers, thereby aggravating the labour supply problems of state firms. Despite all these difficulties, the environment for small business in the Soviet period had some favourable aspects compared with the later years. It was relatively easy to obtain bank loans, import competition was low, and many niches not filled by the state sector were open to exploitation. Most co-operatives received loans as start-up capital (Ivanova and Shashnov, 1991: 60). These advantages disappeared following the implementation of “shock therapy”.

Co-operatives, which had started to come to the market as early as 1987, enjoyed strong growth in 1988, 1989 and 1990. 1988 was a boom year for co-operatives, which by the end of the year employed 1,392,000 people, nine times more than twelve months earlier, while their number grew from

13,900 to 77,500 (Goskomstat, 1988: 178). In 1989 the number of co-operatives grew two and half times to almost 200,000 and the number of people employed three and half times (Goskomstat, 1989: 193). Their total number reached 245,000 in 1990, employing slightly more than 6 million people (Goskomstat, 1991: 55). and accounting for 5-10% of GDP (IMF, WB, OECD and EBRD, 1991, vol.2: 17). They were particularly prominent in the Baltic Republics and Armenia. The share of employment in private firms (broadly defined, including enterprises using equipment leased from state firms) reached about 15% in 1991 (Hughes and Butler, 1993: 274). By 1991, 11% of industrial workers worked for enterprises operating under leasing. They produced 13% of industrial output (Hughes and Butler, 1993: 280). The great majority of industrial co-operatives originated from plants or work units in existing state enterprises (IMF, WB, OECD and EBRD, 1991, vol.2: 18). About four-fifths are estimated to have been sponsored by state enterprises (Ivanova and Shashnov, 1991: 48). Only a negligible proportion of the co-operatives were created from scratch, and these were mostly service, rather than industrial firms (Ivanova and Shashnov, 1991: 59). Co-operatives were mostly engaged in the production of consumer goods, housing construction, communal services and consumer services. In 1990 manufacturing and construction formed 49% of total co-operative output (IMF, WB, OECD and EBRD, 1991, vol.2: 17), a percentage which has changed little in the small business sector in recent years.

The contribution made by co-operatives to the Soviet economy is hard to evaluate. Some were able to produce goods more efficiently than their state counterparts, while in some cases the creation of co-operatives served only to evade price controls and to award bigger salaries to their founders, without any change in production methods, and some had a detrimental effect on the economy as the managers sold off the main assets of the enterprise to enrich themselves. The expectation that co-operatives would fill the niches not served by state enterprises was not realised. The appearance of co-operatives did not bring about an improvement in the deficits of the Soviet economy which, instead, worsened. Presumably co-

operatives played a part in this, by diverting scarce goods from state to private outlets. While they were designed to increase the supply of consumer goods to the population, most of their output was bought by other enterprises (87%), and only 13% by the population, as of July 1990 (Ivanova and Shashnov, 1991: 31). In the end, the experiment with co-operatives, instead of bringing about the results expected by the Soviet leadership, was one of the factors which accelerated the collapse of the planned economy. It did not provide a “jumping off” point for the development of small business.

#### **1.4. ENTREPRENEURSHIP IN EASTERN EUROPE DURING TRANSITION**

In Eastern Europe the small business sector was very small in the communist period compared with advanced market economies, even if there was a thriving black economy, so a strong growth in this sector was expected once the planned economy had been dismantled. The entrepreneurial class was eliminated, along with the institutions of private property, when the communists ascended to power, and the bureaucracy did not allow the entry of new firms in order to maintain the centralisation of control over economic assets. The industrial structure was based on the idea of reaping economies of scale from the production of standardised products. Product differentiation was considered wasteful and contrary to principles of socialist equality. This resulted in a legacy of extensive industrial concentration with a excessive dependence on outmoded heavy industry. In contrast with the trend experienced in Western Europe, the share of manufacturing output accounted for by large firms continued to increase in Eastern Europe until the 1980s, while the small firms' employment share was reduced to almost zero except in the few countries (mainly Poland and Hungary) where a small private sector was tolerated within the constraints of the planned system (Acs, 1996: 15). In Czechoslovakia small firms' contribution to total industrial employment fell from 13% in 1956 to 1.4% in 1986 and the average number of employees

per firm rose from 1,121 to 3,102 (Tschechoslowakei in Zahlen und Fakten reported by Sexton and Kasarda, 1992: 158).

TABLE 1.1

The share of small and medium enterprises in manufacturing employment

Country	Year	Small firms employment share (%)	Year	Small firms employment share (%)	Change
UK	1979	30.1	1986	39.9	+9.8
West Germany	1970	54.8	1987	57.9	+3.1
USA	1976	33.4	1987	35.2	+1.9
Netherlands <sup>2</sup>	1978	36.1	1986	39.9	+3.8
Portugal	1982	68.3	1986	71.8	+3.5
Italy <sup>3</sup> North	1981	44.3	1987	55.2	+10.9
South	1981	61.4	1987	68.4	+7.0
Czechoslovakia	1954	13.0	1988	1.4	-11.6
East Germany			1986	1.1	
Poland <sup>2</sup>	1937	33.0	1985	10.0	-23.0

<sup>1</sup> a small and medium firm is defined as a firm having fewer than 500 employees, unless stated otherwise.

<sup>2</sup> these figures refer to firms with fewer than 100 employees.

<sup>3</sup> these figures refer to firms with up to 200 employees.

Source: Acs, 1996: 14.

Despite the key role small business was assumed to have in the restructuring of the former planned economies (the absorbing of labour released by state industries, increase in market dynamism, the re-orientation and modernisation of the distorted economic structure, introduction of new technologies, etc.) the transition process in Eastern Europe has, however, been characterised by limited attention to the emergence of entrepreneurship. In addition to their role in economic development, privately owned businesses – particularly micro and small-scale enterprises – are also vital in helping establish new democratic principles and institutions in the former communist world. Private enterprises can provide the jobs and income for an emerging middle class that will help to sustain reforms. The emphasis of policy makers was mainly on macroeconomic issues - inflation, a convertible currency, a balanced budget - and issues such as foreign investment, privatisation and banking reforms. Even after the transition became well advanced, small business development has

remained of secondary importance for policy makers in comparison with other policy areas (OECD, 1996b: 74). The boom in new business formation has taken place despite the absence of specific policies to promote it. In Poland the government policy has been based on a *laissez-faire* approach, refraining from taking active measures to stimulate new business formation. The legal environment in Poland was considered by Kondratowicz, Maciejewski and Morawski (1997, 100-101), on the basis of a survey conducted in 1993-4, “not conducive to starting and conducting business activity by small entrepreneurs. On the contrary, it generates by itself a number of important impediments to start-up and growth of SMEs.” They lamented the absence of an internally coherent, unified legal system that would integrate all legal aspects pertaining to small-scale economic activity, the overwhelming number of legal acts concerning small business, some of which are not even published and the limitation of economic freedom because of a continuous increase in the number of activities requiring an administrative permit. In addition, foreign exchange laws were judged to be too restrictive and the regulations excessive. Similarly, in Hungary tax procedures were still in 1999 over-regulated and bank financing for small firms insignificant (The Hungarian Economy, 1999: 4-5). As far as the Czech Republic is concerned, according to Benacek (1997: 236), small business growth seems to lie more in the spontaneous motivation of the members of the population, rather than in the government’s macroeconomic and privatisation policy.

Due to the combined effect of privatisation and new business creation, the private sector underwent an explosive growth in the 1990s in the Czech Republic, Hungary and Poland, while growth was more restrained in Bulgaria, Romania and Russia. In the Czech Republic the private sector’s contribution to the GDP increased from 0.5% in 1989 to around 60% in 1994 and in Poland and Hungary from 28% and 14% respectively to about 55% in the same period (OECD, 1996b: 18). However, these figures can be considered only indicative. The deficiencies in statistical recording make the estimates of the share of the private sector in GDP or employment not

fully comparable. There are ambiguities in the classification of activities as public and private. Firms undergoing privatisation have been classified as private before the conclusion of the privatisation process and no set criteria were used to classify mixed companies as either state or private, even if as a rule this depends on whether the state share is more or less than 50%. Furthermore, statistical recording of private activity and in particular of small business, is insufficient, and a considerable share takes place in the black economy and thereby escapes detection. These deficiencies in the data partly cancel each other out, but it is impossible to say to what extent. According to Benacek (1997: 236) the booming development of the newly created firms in the Czech Republic would be seriously underestimated by the official statistics, accounting for something between 35% and 40% of all economic activity by 1993 instead of the official 26% and 30%.

In September 1995 the Czech Republic and Hungary had more firms relative to their population (68 and 51 respectively per 1,000 people) than the EU average (43) (Economist, 1996: 148), and the great majority of these were newly created firms. However, a considerable proportion of firms are inactive, and many are sole proprietorships which employ only the owner, while most of the remaining are tiny service and trading operations. As declared by Stark (1997: 39) concerning Hungary, “although the number of registered private ventures has sky-rocketed, many are dummy firms, tax evasion is pervasive, and many entrepreneurs (a majority in some categories) still engage in private ventures only as a second job”. The number of self-employed (outside agriculture) increased sharply as well, rising from 650,000 in 1989 to 1.4 million in 1994 in Poland (OECD, 1996b: 30) and from 427,500 in 1990 to 807,000 in 1993 in Hungary (Borish and Noel, 1996: 35). However, a high level of self-employment does not necessarily mean a healthy economy. It can be the result of push factors such as the steep rise in unemployment and the breakdown of the system of social security, rather than pull factors such as greater opportunities in economic activity.

What is significant is the development of manufacturing firms which play the most important role for economic growth. The multiplier benefits of an expansion in the manufacturing sector are likely to be greater than of a similar growth in service sector activity (Smallbone and others, 1997: 227). Dertouzos, Lester and Solow (1989) argue that despite the obvious transformation of economic activity out of manufacturing and into services, manufacturing remains the cornerstone of a modern industrial economy. Even if manufacturing's share of total employment has gone down, its share in the GDP has remained almost unchanged. Considering that the manufacturing sector in the former socialist countries has had to pass from an highly monopolised structure dominated by huge conglomerates based on mass production methods and relatively inflexible production processes, to a more flexible production system, it is clear that the flexibility of small businesses makes them instrumental in fostering this passage.

Expansion in manufacturing has lagged behind the expansion in the service sector due, among other things, to the higher need for capital in starting industrial ventures, and the fact that financial institutions have been very wary of financing such ventures. This is the main reason why the importance of small business has been played down by authors such as Scase and Stark. The first has argued that small businesses in Eastern Europe "appear to have little potential as vehicles for economic growth and for generating rational, capitalist forms of economic production, if only because small business owners overwhelmingly consist of proprietors rather than entrepreneurs. Even the latter are primarily orientated to short-term economic gain for the purpose of conspicuous consumption rather than investment for longer-term capital accumulation." (Scase, 1997: 19). Stark sees most of the private sector growth being concentrated in the informal economy making Hungary similar to the Latin American countries

These opinions could have been valid at the initial stages of reforms, but as the transition has progressed subsequent evidence from the leading transition countries has suggested that the newly established private sector

has been the main force behind the economic recovery in the manufacturing sector, at least in Poland (although growth has been slower than in services). However, even in the Czech Republic, growth has been strongest in small industrial firms, while the contribution of large industrial enterprises has decreased (Borish and Noel, 1996: 34). The share of the former in total industrial production has increased from 3.8% in 1991 to 22.6% in 1997.

TABLE 1.2

The share of small firms in Czech industry (in %)

Year	1991	1992	1993	1994	1995	1996	1997
Share in production	3.8	6.7	10.3	11.6	20.8	22.8	22.6
Share in employment	17.6	16.9	17.5	20.0	26.2	29.1	26.3

Source: official data reported by Bohata and Mladek, 1998: 168

The evidence from Hungary suggests that the industrial restructuring can be largely ascribed to foreign investment. Small businesses have been judged “to have now become, and are likely to remain, the engine of the economy in the years to come” in Poland (Erutku and Vallee, 1997: 113) and the major success story of the 1990s in transition economies in general (Gibb, 1995: 2). In Poland newly created firms contributed two-thirds of the 30% output growth in industry between 1992 and 1995 (Russian Economic Trends, April 1997: 5). A research project on small and medium-sized Polish private enterprises (outside agriculture) came to the conclusion that “mostly new, post-1989 firms that should be considered the source of the private sector economic success and the seeds of the future. The role of the old small enterprises in the Polish economic success of the 1990s must be critically re-assessed and radically scaled-down” (Kondratowicz, Maciejewski and Morawski, 1995: 96). Richter and Schaffer (1996: 8-12), analysing a World Bank survey of 439 industrial firms carried out in mid-1994 in Russia, found that new private manufacturing firms performed much better than privatised and state-owned enterprises. The former were growing rather than contracting, operating at higher levels of capacity utilisation, expanding employment rapidly, and investing more. Among

privatised and state-owned firms there was, instead, little difference. The authors, however, remarked that output growth in new Russian firms lagged significantly behind their Polish counterparts and the difference between newly created firms and privatised and state-owned firms in Poland was larger than that detected in the Russian survey. Another World Bank survey of 200 Polish manufacturing firms (Richter and Schaffer, 1996: 12) indicated that output growth in new Polish firms was 60% on average in 1993, while in new Russian firms it was only 4%. For Russian privatised firms the corresponding indicator was a decrease of 19% which is close to the contraction in industrial output registered in 1994 in Russia. Richter and Schaffer concluded that, although the importance of newly established private enterprises in Russian manufacturing is not negligible, their importance is much smaller than in the other leading transition countries. Had Russian firms followed the same pattern of development as Polish small businesses, an upturn in industry should have taken place a few years after the beginning of the transition, but this has not been the case.

### **1.5. ENTREPRENEURSHIP IN RUSSIA DURING TRANSITION**

Russia and the other former communist states represented an unique opportunity for the study of entrepreneurship. Closed economies shaped by planners have been opened up to market forces. In theory, the changes which have occurred in the Russian economy should have provided a windfall of opportunities for the creation of new enterprises. In Russia all the five sources of market changes indicated by Dean, Meyer and DeCastro have occurred, although the first (increase in demand) can be applied only to a limited number of goods given the economic crisis experienced by the country. This, for example, can be true for some upmarket products for which demand has increased due to the quick enrichment of a small segment of the Russian population. The demise of the command system also led to a change in demand. Russian consumers have moved away from the their poor-looking domestic products towards better looking, but not always better quality, foreign goods. The possibility of engaging in foreign trade without passing through central ministries allowed enterprises to

acquire new technology abroad and find new sources of supply; and the political and legislative environment changed radically. In addition to these five sources of market change, other pull factors included the opportunities arising from the privatisation process and the presence of imbalances between demand and supply in the economy.

As far as push factors are concerned, a powerful factor, valid for the former Soviet Union as well as for the other former socialist states, has been the shrinking or closure of the large state-owned enterprises and the loss of prestige and income suffered by large segments of the population. The miserable salaries for highly-skilled workers such as scientists, doctors and university professors have been a strong incentive for engaging in second jobs or going into full-time self-employment. Second careers have often been pursued without quitting the previous occupation, either because this was tolerated by employers who were aware that this was the only way to keep the worker tied to the firm, or because it was useful for the would-be entrepreneurs to keep their contacts in their original occupations. Kuczi and Lengyei (1995: 78) identified as the main push factor in Russia the hope of raising ones' own living standard, rather than avoiding unemployment, which remained quite low when they carried out their survey in the mid-1990s. However, official unemployment has since grown substantially.

Up to now, the main beneficiaries of market changes have been foreign products. These changes have given rise mainly to speculative operations (import from abroad), rather than to the exploitation of the productive resources to meet this demand, even if there is evidence that in some sectors (food products and pharmaceuticals, for example) Russian firms have been conquering market shares in recent years. There has been both a strong inertia in existing firms, which were largely unable to reconvert their production capabilities, and strong constraints to the development of new firms.

According to Kollermeier (1992: 53) trying to understand the lack of

dynamism by utilising the traditional theories of entrepreneurship and small business is misleading, since these theories are mostly based on relatively stable environments with abundant resources and role models and therefore do not take into consideration the specific aspects of new venture creation in transition economies where resources are very scarce. He therefore implies that demand factors were bound to have a much more restrained effect in the post-socialist countries, and that personality traits and environmental factors can offer little insight.

The personality traits of Russian entrepreneurs (need for achievement, locus of control, risk taking) are believed to be heavily influenced by communist ideology, but the few authors, who have tried to make a comparison, found the personalities of Eastern and Western entrepreneurs to be remarkably similar. A study of Noelle-Neumann (as quoted by Kollermeier, 1992: 50) found the personalities of East and West Germans to be much less dissimilar than expected and Ageev, Gratchev and Hisrich (1995: 372) found Russian entrepreneurs to differ little from entrepreneurs in the United States. Their main personality traits were energy, independence, competitiveness and self-confidence. However, while Russian entrepreneurs may have a high level of self-confidence, believing that they can manage any area of business, they lack basic business skills (Radaev, 1993: 72). Experience is lacking in the transition countries, unless we consider also experience in the informal economy. Given the starkly different economic environment it is likely that the skills acquired by engaging in the informal economy of the socialist states cannot be very useful in setting up a new business in the emerging market economies. Even if the business culture is underdeveloped due to lack of experience, a point to explore is whether the system of cultural rewards and sanctions in Russia counters or complements entrepreneurial motivation. If communist mentality still prevails entrepreneurs are likely to be viewed with suspicion as speculators who enrich themselves at the expense of the population. Sociological studies have shown a rather positive attitude of the population towards private enterprises (Kuczi and Lengyei, 1995: 67; Radaev, 1993: 72; Blinov, 1998:

229). Shiller, Boyko and Korobov (1991: 399) found Russians favourably inclined towards markets, in similar proportions to the populations of the United States, Germany and Japan. Research has shown that an abrupt shift in values has taken place since the beginning of perestroika. This has resulted in entrepreneurship being considered highly prestigious, even if it is not clear how many are ready to start their own business. According to the surveys conducted by the All-Russian Centre for Public Opinion no more than 10% of the population actually declared themselves willing to have their own business (Kuczi and Lengyei, 1995: 67), but opinion polls carried out by the Russian Independent Institute in December 1992 indicated that 80% dreamed of private entrepreneurship and 28% were seriously thinking of starting their own firm (Chepurensko and Vilensky, 1996: 65).

Why despite the favourable attitudes, did small business have a limited impact in Russia? Is the lack of experience enough to explain this? In reality, the reasons that can be put forward to explain why Russian entrepreneurs did not take advantage of market opportunities through the direction of productive activities are numerous. In some sectors foreign products have been able to establish strong barriers to entry by emphasising product differentiation through expensive advertising campaigns, while Russian counterparts can afford only a very limited advertising budget<sup>4</sup>. The fact that, under Russian law, advertising costs are tax-deductible only up to a maximum of 0.5% of total expenditures has not helped. Other reasons are liquidity constraints due to imperfect credit markets, and the same Russian mentality which tends to perceive Russian goods as being of lower quality compared with their Western counterparts.

The contribution of some authors can also be adduced to explain the disappointing growth of small business in Russia. Olson (1982: 72-73) argues that the existence of strong special interest groups in a country limits its ability to adopt new technologies and reallocate resources as a result of

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<sup>4</sup> Ninety per cent of advertisement in Russia promote foreign products and services

changing conditions, with the consequence that economic growth slows down. He notes that, historically, collusion tends to increase over time in stable societies, until dramatic events such as war and revolution destroy these narrow interest groups. In order to avoid collusive behaviour he advocates cancelling special interest legislation and applying anti-trust laws to cartels and collusion. Adopting his line of thinking we can impute the poor performance of the Russian economy to the strong power of interest groups in Russian society, which have, in effect, led to the concession of extremely favourable conditions for well-connected individuals and strongly influenced economic policy, with the effect of discriminating against individuals with poor or no connections. For example, Boyko, Schleifer and Vishny (1993: 163) argue that the fear of competition among powerful state industries has often resulted in administrative barriers to entry against new firms in industry

Another explanation for the slow development of small business in Russia can be found in Baumol's theory on the factors affecting entrepreneurship, which on certain points is similar to Olson's. Baumol's theory is based on the effects that the relative rewards for different types of economic activity have on entrepreneurial behaviour, and hence on economic growth. In his opinion the rules, not the entrepreneurs, undergo substantial changes from one period to another (Baumol, 1988: 1). The entrepreneur always plays a substantial role in society, but that role is not always constructive. He asserts that "while the total supply of entrepreneurs varies among societies, the productive contribution of the society's entrepreneurial activities varies much more because of their allocation between productive activities such as innovation and largely unproductive activities such as rent seeking and organised crime. This allocation is heavily influenced by the relative payoffs society offers to such activities. This implies that policy can influence the allocation of entrepreneurship more effectively than it can influence its supply" (Baumol, 1990: 893). Examples of rent seeking adduced by Baumol are the medieval wars over land and castles, lobbying

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(Zhuplev, Konkov and Kiesner, 1998: 508).

for legislation which protects an industry from competition, tax evasion and litigation over monopoly licences. No doubt in the Russian context this is a strong argument, and has also been emphasised by Nelson and Kuzes (1995a: 133-136). Vast fortunes have been amassed in Russia through rent-seeking (for example, illegal sale of precious raw materials abroad). The system has been frequently denounced by Russian entrepreneurs, who feel like hostages to the unlawful requests of state officials and criminal organisations. Russia and four other former Soviet republics have been given the highest rating for official corruption by the “*Economist’s Intelligence Unit*” (Louis Berger ..., 1998: 17).

A further possible reason can be traced to the absence or low development of supporting networks, which, in the opinion of Brunner (1993: 510), are a vital component for the development of the new economic structures of these emerging economies. Brunner criticises the emphasis given by policy makers to the privatisation of state enterprises, the solution favoured by neo-classical economists, who assumed the change of property to be necessary to make economic agents responsive to market signals. In Brunner’s opinion, this approach ignores the basic fact that market economies have evolved through a continuous process of trials and errors. For this reason, privatisation can have only limited success. He, instead, suggests an evolutionary strategy, based on the promotion of entrepreneurship, in order to facilitate the process of economic transformation in Eastern Europe. For this aim, the state must foster innovation through research and development aid, training and advisory centres. An effective network of support structures in the country is necessary to favour the “continuous reorganisation of industrial structures through a sequence of random trials by firms and systematic competitive elimination of errors” (Brunner, 1993: 508). The outcome of this process is the gradual emergence of growth centres in the domestic economy.

Until recently, in Russia formal networks have been hardly used. Banks tend to ignore new firms, consulting is mostly unaffordable and business

associations reach a limited number of entrepreneurs. A sense of suspicion towards these organisations is prevalent among local businessmen. It is not clear whether this is due to ignorance of the role that the formal system can play, or to the poor efficiency of the formal system in responding to the needs of the entrepreneurs. In the first case there is a strong argument to increase awareness of the kind of advice and help that formal sources have to offer.

In Russia, given the economic turmoil and the underdevelopment of market institutions, it greatly helps to take advantage of pre-existing informal networks, which can serve as a vehicle for business transactions. These networks reduce the cost of transacting by facilitating the development of high-trust relationships. For new entrepreneurs with few connections, it will take time to build a network of trusted partners since trust, the basic element determining the solidity of the link, usually evolves slowly.

The importance of informal networks explains the emergence of a specific group of Russian entrepreneurs: the former communists. Struthers, Young and Wylie (1996: 154) argue that even if in theory the Communist party might have served as a basis for business networking, in practice, this did not happen because the party was not known for developing high-trust relationships among its members, and because of the strong bias of party ideology against private business enterprise and the profit motive. In their opinion, higher educational institutions create more effective networks for new enterprise development in Russia. In practice, many of the early entrepreneurs came from the ranks of the communist party. Kryshantovskaya (1994) found in 1994 that seventeen of the leading businessmen in Russia entered private business from the Komsomol<sup>5</sup> apparatus, which was one of the earliest sources of successful entrepreneurs. These created new firms, frequently utilising state resources rather than building new firms from scratch, and in developing their business were able to exploit to their advantage their wide network of established relationships

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<sup>5</sup> Communist Youth League of the USSR

with high-ranking officials. This, for example, has allowed them to have access to financial resources through their contacts in the banking system or to receive contracts from local administrations. Many of the highly-placed bureaucrats remained in positions of power even after the downfall of communism, and the organisations they headed were converted in order to obtain a role in the market economy. For example, when pillars of central planning such as industrial branch ministries were dismantled, new organisations were created comprising most of the enterprises belonging to the former ministries. In Russia, unlike the Czech Republic and to a lesser degree Poland and Hungary, former communists were not removed from their positions, and this gave them an useful advantage in business. The continuous dominance by the same elite<sup>6</sup> explains why collusion and rent seeking are so widespread. The situation may, however, have changed overtime with the continuous diminution of the influence of this former communist elite, as new economic actors slowly emerge.

## 1.6. CONCLUSION

Although the importance of small business has vastly increased, especially in the last thirty years, a unique trend of development in small business does not exist. Advanced market economies have experienced widely different developments and there is no indication that the differences are narrowing. The personality trait approach can offer some insights on what make an entrepreneur, but its assumptions cannot be generalised because entrepreneurs are a class with widely different features. Culture and their personal background are also assumed to exert an important influence on the decision to become an entrepreneur, but give little insight in the context of the post-communist economies. The personality trait approach, focusing on the characteristics of entrepreneurs' personalities and motivation, and the

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<sup>6</sup> Huber and Worgotter (1998: 83) assert that "substantial empirical evidence concerning corporate structures and financial-industrial groups in Russia suggests that relationships forged under the planning system remain operative, especially in large scale industry". They also cite evidence by other authors on this point, including Bim (1996: 477), who found that 73% of managers interviewed admitted to owning firms that were either deliverers or suppliers to the firm they managed. See also Silverman and Yanowitch (1997: 118-127) and Knabe (1998) on the economic power of the former Soviet nomenklatura.

approach centred on environmental factors can lead to the conclusion that policies to stimulate small business development are of little use. There is, indeed, conflicting evidence as to the efficacy of a small business policy, but in the former communist countries the scarcity of business education and the reluctance of banks to finance new enterprises all call for a state role in overcoming these difficulties. However, even with little state assistance, small business growth was a natural phenomenon which developed following the switch to the market. This process, which initially concerned mainly the service sector, has also spread to industry, especially in Poland and to a lesser degree in the Czech Republic.

In Russia, the development of small business has been slow, although the liberalisation of the market has resulted in countless opportunities. Already in the Soviet period, the policy of allowing private enterprises in certain business activities in order to increase the supply of scarce goods in the consumer sector has not produced the expected results. In fact, it may have exacerbated these shortages. Given the particular conditions of the economic transition small business theories are of little use when applied to Russia. The Russian business environment requires entrepreneurs who are able to cope with highly stressful conditions: a predatory state which sets unclear and constantly changing rules and makes law-breaking almost obligatory to ensure survival and the absence of penalties for non-payment. The diffusion of this latter phenomenon makes business relations risky unless one is able to work with trusted partners. This explains why previous members of the nomenklatura or managers, who could rely on personal relationships developed in Soviet times, had a distinct advantage, especially in the early years of the transition. Connections were especially important in the early years in order to obtain access to premises, equipment and inputs, although there is evidence that the market is slowly becoming more transparent. In addition to the above-mentioned reasons, entrepreneurship is conditioned by a scarcity of business skills, which is due to the lack of experience, and by a variety of other factors (limited access to resources, the stronger market skills of foreign manufacturers, lack of formal networks, collusion,

monopoly power, bureaucratic obstacles, etc.). For this reason, factors which have been found to influence the rate of creation of new firms have a limited effect in Russia. The lack of experience and business education, reflected in the weak basis (insufficient knowledge of the market environment, lack of preliminary study) on which a firm is created, ensures that the creation of new enterprises involves a long process of trial and error with a high turnover of firms.

Having discussed the strong influence of interest groups on policy making, the next chapter will examine the actual legislative framework as well as the specific measures on small business and factors commonly regarded as critical in Russia (sources of finance and crime).

## 2. THE BUSINESS ENVIRONMENT IN RUSSIA

### INTRODUCTION

This chapter examines the main features of the business environment which affect small businesses in Russia: taxation, the legal framework, regulations, macroeconomic framework, crime, sources of finance and state policy. Taxation is a recurrent theme in this research and will also be discussed several times in later chapters. The establishment of a fully-fledged market economy seemed to be a relatively straightforward task prior to the transition to the market, entailing the implementation of the appropriate laws. Instead, after almost a decade, legislation seems to serve the purpose of discouraging business, rather than providing a framework in which it can prosper. This chapter has a large section on the tax system implemented in the post-Soviet period, which represents the biggest constraint on small business in Russia. For years a simplification of the system has been on the agenda, but to no avail so far. The variety of sources from which taxes are gathered and the lack of clear delineation of power have created a maze of overlapping legislation and an array of regulations with which a small business has to comply. Differing interpretations of legislation create the potential of disputes with tax authorities who have ample powers which are often misused. In the light of these developments the following section examines in more detail the legislative approach to small business of the Russian government. Despite the key role small business was expected to play in the economic transformation, East European countries have neglected this sector, by adopting a *laissez faire* approach. This section analyses how the Russian government has dealt with this issue, which was recognised at the beginning of the transition process as being of vital importance for economic recovery to take place. The various measures enacted by the federal government and their impact is discussed. Since the early transition years, laws have been passed to encourage small business development, and privileges conceded to selected activities. The programmes of small business support, which should have

provided the guidelines for the small business policy, are described in detail. It is also explained why the state policy failed to produce the expected results. In addition to the legislative chaos, small businesses have to face widespread criminal activity and a highly unstable macroeconomic framework characterised, especially in 1992-1995, by high inflation and falling consumption. A section is also dedicated to the availability of finance. Commonly considered a critical factor in the development of small business, it is even more so in Russia, given the loss of savings by the population in the hyperinflation of 1992-3. Finally, I try to detect the reasons why small business has expanded more in the leading transition countries (Poland, Hungary and the Czech Republic) than in Russia.

## **2.1. MACROECONOMIC FRAMEWORK**

The Russian transition was based on the shock therapy approach already implemented in Poland. The cornerstones of the reform strategy, which took effect from January 1992, were the curtailment of the centralised supply system and the price liberalisation which covered approximately 90% of retail prices and 80% of wholesale prices. The co-ordinating body of material supplies (the successor to the GOSSNAB) was finally dismantled in October 1992. State procurements continued to be placed only for agriculture produce, military equipment and a few other items. The liberalisation was to be accompanied by a restrictive fiscal and financial policy in accordance with the agreement reached with the IMF which set the customary limit for the budget deficit (5% of the GDP) and precise ceilings for central bank credit expansion as a condition to receiving IMF loans. Budget expenditures were cut by 10% of the GDP as the switch to the new system of taxation entailed a substantial decrease of total government revenues.

The liberalisation of prices is a necessary prerequisite for the economic transformation from plan to market. In economic theory the free interplay of demand and supply brings about the optimal allocation of resources. Prices

which reflect the scarcity values of all goods provide the incentives for economic decision makers to allocate resources to the best possible use. In reality, price liberalisation is still not yet complete. Price controls are still used by local administrations in Russia as well as restrictions on the movement of locally made goods out of the region (EBRD, 1998a: 186). The almost fivefold increase in retail prices in the first quarter of 1992 practically absorbed the monetary overhang, but while in countries such as Poland, the Czech Republic, Hungary and the Slovak Republic high inflation lasted for a short period - only Poland had annual inflation of more than 100% in 1990 - in Russia the achievement of macroeconomic stabilisation was derailed by the huge upsurge in credits issued by the Central Bank from the middle of 1992. In this way the burden of sustaining enterprises was shifted from the budget to the printing presses. The large budget deficits incurred between 1992 and 1995 were largely financed by money emission as they could not be covered by the domestic and foreign capital markets. Because of this in 1992-1995 Russia experienced very high inflation rates. Inflation peaked at more than 1,000% in 1992 and did not fall below 100% until 1996. Inflation was reduced in 1997, but picked up again after the rouble devaluation in August 1998.

Relative price stability is important because the information content of prices is assumed to be higher in a stable environment. For this reason monetary expansion must be kept within a range compatible with the official objectives of growth, inflation and balance of payments. Several studies have emphasised that growth is positively correlated to low inflation as well as high openness to foreign markets (Easterly and others, 1994: 1; Fischer, 1993: 1). In fact, instability in the macroeconomic framework in addition to reducing the efficacy of the price mechanism, discourages investment and is likely to lead to capital flight. Consequently, it tends to diminish the level of productivity and its rate of increase (Fischer, 1993). The effects of high inflation are to discourage the population from saving, to prevent the banks from issuing long-term loans and to make enterprise managers reluctant to invest in new equipment. In fact, in a climate of

uncertainty, managers tend to allocate most of the income to current consumption, while bank capital is usually invested in short-term speculative transactions and families prefer to purchase foreign currency or residential property, which are considered safer hedges against inflation. For these reasons investment is likely to fall to very low levels - even below replacement needs - leading to a progressive decapitalisation of firms and to a worsening of capital productivity. In effect, investment registered a very large decrease, accounting in 1998 at barely 20.7% of the analogous figure in 1991 and the output drop by far exceeded the expectations. GDP in 1998 was 57.5% of its level in 1990, while industrial production was 43%. The share of services in GDP has, therefore, expanded and has exceeded industry since 1994. Personal consumption has, instead, had a divergent trend dropping by 41% in one year alone in 1992, rising by 11% and 10% in 1993 and 1994 and dropping again slightly in the following years, except in 1997 when it posted a small increase. Overall personal consumption has dropped more or less the same as GDP.

TABLE 2.1.  
Main economic indicators in Russia

	1991	1992	1993	1994	1995	1996	1997	1998
GDP <sup>1)</sup>	-5.0	-14.5	-8.7	-12.6	-4.1	-3.5	+0.8	-4.6
Industrial Production. <sup>1)</sup>	-8	-18.8	-16.2	-22.8	-4.7	-4.0	+2	-5
Personal Consumption <sup>1)</sup>		-41	+11	+10	-7	-1	+1.1	-5.5
Gross fixed Investment <sup>1)</sup>		-41.5	-25.8	-26	-7.5	-18.5	-6	-9
GDP <sup>2)</sup>	95	81	74	65	62	60	60.5	57.5
Ind. Prod. <sup>2)</sup>	92	74.7	62.6	48.3	46.1	44.2	45.1	42.8
Pers. Cons. <sup>3)</sup>	100	59	65.5	72.0	67.0	66.3	67.1	63.4
Gross fixed <sup>3)</sup>	100	58.5	43.4	32.1	29.7	24.2	22.8	20.7

<sup>1)</sup> changes in percentages compared with the previous year; <sup>2)</sup> 1990=100; <sup>3)</sup> 1991=100

Sources: EBRD, 1998a: 225 and Russian Economic Trends, 1996, no. 3: 138; 1997, no. 4: 66; 1999, no. 2: 101-102.

Russia was bound to be affected more than the East European countries by the downfall of the planned system due to the factors listed below, but the fact that the recession was so long points to the existence of constraints which will be discussed in section 2.8. These factors are:

- the slashing of military spending which represented an enormous burden

for the economy. The valuation of the size of the military and defence sector during the last two decades of Soviet rule varies from 15% to 30% of the GNP (Ericson, 1990: 15; Swain, 1990: 103). Even the lower figure was greater than the corresponding percentage in the other East European countries and more than twice as much as in the United States.

- the economic structure was more centralised and distorted in the Soviet Union than in the other socialist countries.
- the disruption of trade with the republics of the former Soviet Union. Calculations based on input-output tables for 1987 showed that a 50% decrease in both exports and imports with all other republics of the Soviet Union would result in a 25% drop in national income for Russia (Daviddi and Espa, 1993: 13). The extreme division of labour within the Soviet Union made these economies much more dependent on each other than they would have been under a free market system. Different stages of production were intentionally located in different republics.

We can also presume that given the barriers to the mobility of capital and labour, and the scarcity of internal resources which can be earmarked for new investments, the liberalisation of foreign trade has exacerbated the output drop in the consumer goods sector which, in general, fares poorly against Western goods. Russia is undergoing a regressive specialisation, as the revenues accruing from the export of its raw materials, instead of being utilised for importing much needed technology, are stashed abroad or used to import consumer goods which squeeze the domestic products out of the market. The deep crisis affecting the producer goods sector is due to the collapse of investment. The reduction of investment has made the industrial structure increasingly obsolete and outworn. Privatisation has still to result in an improved performance of the companies concerned. Up to end 1997 privatised enterprises numbered 123,000, while wholly-owned state enterprises were down to 88,000 from 205,000 in 1992 (EBRD, 1997: 195). However, the state has retained large stakes in a great number of privatised enterprises.

Considering the large output drop, unemployment has not increased as much as expected reaching 11.9% in 1998 (calculated according to the ILO concept). However, it is still continuing to increase in 1999 - it went up to 14% in the first quarter of 1999 - in spite of the positive output trend, indicating that the process of reduction of excess personnel has not yet been completed (Russian Economic Trends, 1999, no. 2: 107).

A recovery set in just a few quarter after the August 1998 crisis which had been caused by the government's default on its domestic debt. This provoked a chain reaction by which the major domestic banks, which had largely invested their assets in state bonds, rapidly became insolvent, paralysing the entire banking system. By the end of the year the rouble had lost two-thirds of its value leading to a spurt of inflation and to a sharp fall in real wages. Real wages in July 1999 were 36% lower than one year earlier (Russian Economic Trends, September 1999: 4). The macroeconomic stabilisation achieved in the few years leading to August 1998, which seemed to be a prelude to a turnaround in the economy, turned by September 1998 into a depression. However, this had a very uneven impact. While services, which had boomed mainly in Moscow, St. Petersburg and few other cities, were badly affected, the consequences of the crisis on the rest of the country were less dramatic. Even smaller banks (the vast majority of non-Moscow banks), having generally invested much less in state bonds, survived the crisis relatively unscathed. In the end, the crisis was shorter-lived than initially expected. The collapse of the major banks may have disrupted economic activity in the aftermath of the crisis and resulted in a considerable number of people losing their savings, but it did not have serious consequences for the Russian economy as the role of the banking sector in the whole economy was very small and the share of loans in total GDP was well below that in other East European countries.

The rouble devaluation had also some beneficial consequences. It partly redressed the distortions in an economy which was relying too much on imports and producing little by giving the opportunity to domestic

manufacturers to fill the niches left open by foreign goods squeezed out of the market. Export-oriented sectors were also stimulated by the devaluation. For this reason the slump in industry was soon reversed. Recovery began in the second quarter following the crash. As imports declined by 50%, import-competing industries flourished, even if a shortage of domestically produced inputs did not allow domestic producers in several sectors (e.g., the meat industry) to reap the full benefits of the devaluation. Compared with July 1998 machinery production was 27% higher, textiles 31% higher and food processing 18% higher one year later (Russian Economic Trends, September 1999: 4). Total industrial production was 4.5% higher in the first seven months of 1999 compared with the same period of the previous year and rail freight, which "*Russian Economic Trends*" (1999, no. 3: 20) describes as "the most robust measure of current industrial activity", went up 15% in the last twelve months to July 1999. However, growth in industrial production has taken place without a corresponding increase in investments, and this casts doubts on whether it can be sustained in the long-term. Profits and cash flows have also increased, while barter and wage arrears have gone down. In addition, the improved performance of the economy led to a rise in federal tax revenues from 11% of the GDP in the first half of 1998 to 13.1% in the first half of 1999 (Russian Economic Trends, 1999, no. 3: 22).

## **2.2. TAX LEGISLATION**

The basis of the tax legislation was laid in 1991, when a package of laws necessary to establish a market economy was passed by the Russian Parliament, but the countless additions and amendments to the tax legislation have made the situation so complicated that it is sometimes impossible for taxpayers to know whether they are complying with the law or not. There have been some minor fiscal reforms in the last few years, but, according to the European Bank for Reconstruction and Development (EBRD), the tax system remains unstable, non-transparent and highly onerous for enterprises (EBRD, 1997: 197).

Russia has a three-tier tax system consisting of federal, regional and local taxes. It does not have a tax code. Tax matters are regulated by laws, Presidential decrees and regulations, decrees and regulations of the government, documents of regional and local administrative bodies, normative acts of ministries and state departments and instructions, explanations and letters of the State Tax Service and the Ministry of Finance. The highest in the hierarchy are laws approved by the Parliament and the constitution. Subordinate legislation must conform to parliamentary laws. In reality, this is not always the case. As a clear separation of powers is often lacking, and these bodies often consider each other as competitors, the result is a maze of overlapping and contradictory legislation. In 1997 the tax system was regulated by about 2,000 legislative acts (EBRD, 1997: 121).

Many federal tax laws are so vague and incomplete that they cannot be applied, but have to be supplemented by instructions and letters of the State Tax Service or the Ministry of Finance. The lack of an implementation mechanism is another common defect of Russian legislative acts. To implement these laws it is necessary for corresponding normative acts to be enacted. For this reason several laws which, in theory, should be enforced are never implemented. Keeping track of new legislation is a hair-raising task. There is a great number of newspapers and magazines - it is hard to say how many - which are entitled to publish federal and subordinate legislation of the Russian government and its agencies. To make matters more difficult, laws are sometimes published in a different magazine from where they are supposed to be published, and may even be applied before their publication.

Recourse to the tax inspectorate to obtain clarification is, particularly in big cities, of little use, as inspectors are in most cases very reluctant to provide information about new regulations. They may even conceal information about new taxes in order to extract large penalties or bribes. The problem

with tax inspectors is that they are understaffed, ill-equipped, lacking basic equipment such as calculators and computers, and underpaid, receiving wages that sometimes are paid months later. This, coupled with the fact that tax officials have a high degree of discretion in applying penalties leaves ample room for abuse and corruption and a very uneven treatment of taxpayers. Tax officials are notorious for carrying out repeated raids on the same firm and are capable of driving thriving firms to failure. Under pressure to collect taxes they often act without taking into consideration the consequences of their actions, justifying them arbitrarily, in the knowledge that few cases come to court. Even if a document produced by one of the various sources of legislation may not be legally enforceable, they might consider it effective (Antel, 1997: 1). Matters are not helped by the fact that their benefits are linked to a pool of collected funds. According to the Moscow office of Arthur Andersen this situation has become worse since the federal government has instructed local authorities “to ignore objectivity in taxpayer dealings and raise more revenues irrespective of reasonable legal, procedural or commercial business considerations which might inconveniently get in the way” (Antel, 1997: 3). Taxes can be collected unconditionally, for example, by withdrawing funds from the bank account of an enterprise, without even informing the company concerned. This was done five million times in 1997 according to figures from the State Tax Service (EBRD, 1998a: 16). In accordance with the law the value of the funds expropriated may exceed by three-four times the sum of taxes in arrears due to the high incidence of fines and penalties. The size of the penalty does not depend on whether the tax violation was a deliberate act or originated from a misinterpretation of the tax law. Tax fines are very heavy even for minor offences. A common source of contention is the different interpretation of a law by tax bodies and firms’ accountants. However, the ambiguity in the legislation also enables many firms to exploit the widespread legal loopholes, encouraging them to operate at the limits of legality - itself imposing a further administrative burden on the tax inspectorate. For example, a tax had to be introduced to combat the habit of paying bank employees partly in highly remunerative bank deposits and soft

loans. A 15% income tax was levied on personal accounts in which the interest rate exceeds the Central Bank's refinancing rate (the 15% applies only to the portion of the yield which exceeds the Central Bank rate). An analogous levy was introduced on loans if the interest is less than 2/3 of the Central Bank rate.

Members of the Federation are free to establish taxes as the current legislation does not set any ceiling on the number of taxes which can be introduced. The decree no. 2270 signed by the President on 22 December 1993 ("On Several Changes in the System of Taxation and in the Relationship between Budgets of Various Levels") allowed local authorities to levy additional taxes at their will. This has resulted in a multitude of regional and local taxes on top of the fourteen federal taxes. There were approximately 150 regional and local taxes in 1995, according to an estimate of the Ministry of Finance (Pepelyayev, 1996: 42), some of which are very odd. For example, Chuvashia introduced a tax on investment outside its border and Kursk one on production decrease. There are taxes on football teams, scientific expeditions, etc. Some regions have even enacted import and export tariffs on trade with other regions, in spite of the fact that this contradicts the constitution of the Russian Federation, which states that inside Russia it is forbidden to set up customs points, introduce tariffs or other obstructions to free trade (Boiarskii and Gavriiliuk, 1996: 24). By the beginning of 1999 the number of federal taxes had increased to thirty, plus more than 170 local and regional taxes (CCET, 1998: 45).

In 1994 a firm had to deal with an average of fourteen federal, four regional and as many as twenty-two local taxes - in total up to forty different taxes (Sheppard, 1995: 191). The federal taxes which were levied in the whole territory of Russia in 1994 were:

- value added tax
- excise duties
- tax from exchange activities
- tax on securities transactions

- customs duty
- contributions for the replacement of the mineral raw-material base
- payments for the use of natural resources
- profits tax on enterprises (absorbing the tax on excess labour cost)
- income tax on individuals
- road fund taxes
- levies on the cost of arms
- government fees (or state duties)
- tax on property inherited or received as a gift
- levy on the use of the names "Russia" and "Russian Federation" in a corporate name.

The number is, however, constantly changing. In 1998 regional legislative bodies were allowed to introduce a tax on the sale of certain types of goods and services of no more than 5% of the sale price. The total number of taxes a company was subject to in 1998 varied from 40-50 (CCET, 1998: 45). Some of the corporate taxes are based on total revenues instead of profits, thus making the tax burden on activities with low margin extremely high. The profits tax was 35% (13% going to the federal budget and 22% to the local budget) until the end of 1993, when members of the Federation gained the right to increase their share of the profits tax from 22% to up to 30% for banks and insurance companies and 25% for enterprises in other sectors. The ceiling for the rate of the property tax was also raised from 1% to 2% of the assets value<sup>1</sup> (Presidential decree no. 2270). In mid-1994 the local rate of the profits tax for the non-financial sector was brought back to 22% and in 1999 was further reduced to 19%. At the same time the federal rate was also reduced to 11%, making a total of 30%.

Even if the profits tax is nominally lower in Russia than in most of Western Europe, the method of assessing the tax base makes it higher. Taxable profits were boosted by the existence of strict limits on deductions for wage

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<sup>1</sup> This is a tax on the annual average balance-sheet value of fixed and intangible assets less depreciation, inventory, work-in-process, raw materials, supplies and prepaid expenses.

costs up to the end of 1996 and by the lack of indexation of depreciation and inventories to inflation. Fixed assets and inventories were revalued only sporadically. In the presence of extremely high inflation, as between 1992 and 1995, this meant that depreciation allowances were quickly eroded by inflation and taxable profits artificially boosted, especially in the years in which there was no revaluation. In addition, extraordinary items are not deductible and several items such as loan interest, advertising expenses, training costs and insurance premiums cannot be deducted in full. Interest on loans can be deducted at the central bank rate<sup>2</sup>. Gains and losses from foreign currency exchanges were excluded from the taxable base until the beginning of 1997. Thus a company's taxable income may have little relation to its trading costs.

The only privileges accorded to enterprises are the possibility of deducting from the taxable income the expenses on capital investment and research (Presidential decree no. 2270) and a 50% reduction in the profits tax if disabled persons and/or pensioners make up at least 70% of the total number of employees. This has created a market of "staff agencies" offering the disabled or pensioners at minimal cost to enterprises looking for ways to reduce the tax burden. At the beginning of 1997 amendments to the law "On Corporate Profits Tax" limited to 50% the deduction for capital expenditure.

According to a study carried out in the spring of 1994, taking into account all levels of taxation, from local to federal, an enterprise ends up paying about 80-90% of the reported profits in taxes (Avilova, Pripisnov and Chepurenko, 1996b: 13), and this percentage has not decreased in recent years. This is the rule, unless the firm is one of the many enterprises which receives tax privileges. A vast array of benefits is applied to specific types of economic activity or to specific enterprises. These may be rate reductions on certain taxes, tax deferrals or exemptions for a given period. The practice of conceding tax privileges has been drastically reduced since 1992

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<sup>2</sup>Most of these limitations will be removed if the new tax code is approved.

by the federal government, but is still widely used by local governments for activities deemed as priorities.

A new tax code was worked out in 1995-6 and presented to the State Parliament at the beginning of 1997. The main points of the code are:

- simplification of the tax system and removal of the inconsistencies in the tax legislation.
- switching some of the tax burden from enterprises to individuals. It is planned to broaden the tax base and lower the rates.
- a reduction in the number of taxes.
- a reduction in tax privileges. The power of regional governments in granting tax exemptions is restricted, putting an end to tax competition between the regions.
- the prohibition of the retrospective enactment of the tax laws.
- the determination of the division of power among federal, regional and local authorities. All local taxes whose collection is admissible on the territory of Russia are listed, together with the maximum applicable rate.
- incentives for investment.

The first part of the tax code was approved in July 1998, while for the remaining parts there is no indication of whether and when they will be enacted. The first part sets the fundamental rules of the tax system and clarifies taxpayer rights, but does not cover the reforms in individual taxes suggested by the IMF, which are included in the remaining part of the code (EBRD, 1998a: 187). One of the main points of the first part is to delineate which taxes are admissible, but an amendment passed in April 1999 allowed the introduction of any additional tax and increases in the rate of the existing taxes (Kochetov, 1999: 1).

Russia has one of the highest tax burdens in the world, but the burden is very unevenly distributed. In 1995 the income tax accounted for only 8% of total receipts, against an average of 29.7% in the OECD countries, while the

profits tax accounted for 26% compared with 7.3% in the OECD countries (Sazhina, 1996: 22; Russian Economic Trends, 1996, no. 2: 22), in spite of the fact that just 17% of companies are estimated to pay taxes regularly and in full. At least a third publish no accounts and make no tax payment (Summers, 1997: 5). Industry, which in 1995 accounted for 34.2% of the GDP, supplied 52.2% of the tax revenues (Afanas'ev, 1996: 1). Because of the government's leniency in dealing with large firms the 100 biggest tax debtors account for about 40% of the arrears to the federal budget (Russian Economic Trends, December 1997: VII). On the other hand, some of these firms (mostly utility providers) are owed a huge amount because their bills are often not paid<sup>3</sup>. Individuals are even less tax abiding: only seven million citizens filled in an income declaration in 1995 (Ryzhov, 1997: 1) and 95% fit in the lowest tax bracket of 12% (Shatalov, 1995: 10). The tax service does not have a single database of taxpayers; historical records - very incomplete - are kept on paper. Very low also are the revenues from the taxation of natural resources and excise taxes. The share of taxes in GDP has gone down from slightly less than 40% in 1993 (Russian Economic Trends, Dec. 1997: V) to 33.5%<sup>4</sup> in 1997 (Russian Economic Trends, July 1998: I), which is less than in most European countries, but comparable to the levels in the United States and Japan. However, considering that 25% of the official Russian GDP is represented by the unofficial economy, tax revenues in reality make up about 40% of the official economy. Although the level of collection is respectable, the state is chronically short of funds when it comes to finance the various items in the budget, as the economic collapse has reduced the amount of tax revenues year after year. The gap in revenues is aggravated by the fact that a substantial proportion of taxes are paid in non-monetary forms (commodity credits, tax offsets and promissory notes) (EBRD, 1997: 197), and over a third of the revenues are collected by various off-budgetary funds where the cash is strictly earmarked for specific purposes (Russian Economic Trends,

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<sup>3</sup> The tax agency believes that more than half of these non-payments have in fact been paid into the personal accounts of the managers of these firms (Current Digest of the Post-Soviet Press, 1996, no. 41: 6).

<sup>4</sup> This includes the federal and local budgets as well as the major extra budgetary funds, the only for which data are available.

Dec. 1997: VIII).

### **2.3. THE LEGISLATIVE FRAMEWORK FOR CONDUCTING BUSINESS**

At the time of the various plans for a quick transition from planning to market in the late 1980s there was a widespread conviction among Russian economists that just importing the legal system in force in advanced market economies was enough to create a well-functioning market. In reality, the functioning of the legislative framework for the conduct of business is hampered by the limited trust of Russians for the law due to historical circumstances. Like tax officials, bureaucrats are renowned for interpreting the law at their will. A survey carried out in Moscow found that that 65% of its inhabitants believed that law enforcement in Moscow is dependent on the whims of officials rather than on the rule of the law (Golovachev, 1998: 1). This kind of behaviour is facilitated by the fact that despite the relatively long period since the transition began, the legislative and normative basis for conducting business is in many fields still inadequate and unclear. The cornerstone of a market economy is deemed to be the presence of property rights, but property and contract laws in Russia are unclear and the legal recourse to courts to settle disputes or collect debts is of no use in most cases. By legal means there is no assurance that contracts will be enforceable and even if a company is able to prove a contract breach before a Russian court, the prospects of recovering damages are small. Russian courts are inexperienced in resolving commercial disputes, and lack many of the procedural mechanisms typically found in the West to enforce and protect legal rights. The courts' power to enforce decisions, especially against government agencies, remains questionable. In a situation where contract breaches are an ordinary occurrence these legislative gaps represent a significant hindrance to economic development. A survey reported that violations of business agreements are experienced frequently by 41% of business managers and occasionally by a further 53%. Only 7% have never experienced this kind of problem (CCET, 1998: 20). The result is that

organised crime is utilised to protect property rights. In addition to extorting payments for protection, Mafia groups provide legal services such as debt collection and contract enforcement. More than 50% of the entrepreneurs resort to informal methods (which include the use of security agents or criminal gangs) to settle business disputes (OECD, 1998b: 4).

Another main shortcoming of the Russian legislative system is the existence of several sources of legislation which give rise to conflicting regulations and make it difficult to keep up-to-date with the current legislation. Taking the year 1992 as an example some 1,727 decrees and 8,121 directives were issued by the President. The Congress of People's Deputies issued fifty-nine directives and two laws, the Supreme Soviet 290 decrees and 112 laws, the chairman and the deputy of the Supreme Soviet sixty-six and twenty directives respectively, the Council of Nationalities seventy decrees. In addition approximately 40,000 laws, directives and regulations were issued by local authorities each week (Layard, 1996: 179).

Schleifer (1997: 23) argues further that the environment in Russia is not very business-friendly also because the incentives of local politicians do not encourage them to support private business, as in most regions they are appointed directly by the President. Therefore, they do not have to respond to a local electorate and according to Schleifer are often inclined to undermine private business since it could represent a future challenge to them. In his opinion they fear that once the private economy grows they will not be accepted by these new business elite. By contrast, in Poland, local officials are elected and are therefore more interested in promoting the well-being of their constituency. The business climate in Russia has, however, differed considerably from region to region depending on the attitude of local authorities. Whether elected officials have shown a more positive attitude requires more detailed research. As far as St. Petersburg is concerned, having an elected mayor has not resulted in more attention being given to small business until recently.

In some regions the still widespread negative attitudes towards private entrepreneurs have resulted in a plethora of bureaucratic obstacles to the development of private enterprise. Local authorities have often ignored the tax privileges conceded to small firms and have required licences for certain activities, even if not required by federal legislation; they have made the registration of enterprises more difficult, hampered access to industrial and commercial premises, favoured certain firms in the concession of tax advantages and so on (Kabakov and Koscparmak, 1997: 45; Tsyganov, 1997: 98). As local authorities control the supply of land and premises, they possess a powerful tool to restrict competition and personal connections are often necessary to have access to these. In 1996 anti-monopoly bodies initiated 489 lawsuits regarding the infringement of the competition laws (Tsyganov, 1997: 99). The law approved in 1995, "On the Introduction of Changes and Additions to the Law On Competition and Restriction of Monopoly Activity in the Market'" gave the Anti-Monopoly Committee ample powers to control the compliance of federal and local administrations with the competition law. This law prohibits local administrations from:

- introducing restrictions to the creation of new firms and forbidding the setting-up of specific kinds of businesses.
- granting unjustified privileges to specific firms, thereby placing them in an advantageous position in relation to other firms working in the same market.

The Committee, which acquired ministerial status in 1995, may impose fines, invalidate contracts and issue binding orders to state agencies and private companies (EBRD, 1997: 196). However, as far as St. Petersburg is concerned the effectiveness of this body has been very limited and the introduction of this law does not seem to have had any significant impact.

On the other hand, some local administrations have used a variety of measures to promote entrepreneurship: additional tax privileges, guarantees to financial institutions working with small businesses, rent on advantageous terms of buildings belonging to the municipality and the

setting up of science parks, business incubators and consulting and training centres for small businesses. In recent years there has been a greater recognition among local administrators of the importance of promoting small business - as explained by Ioffe, the President of the Russian Agency for the Development of Small Business and by leading researchers in this field (Delovaia Moskva Segodnia, 1997: 4). For example, obtaining premises has become easier according to surveys (IPSSA, 1998: 72).

#### **2.4. STATE POLICY TOWARDS SMALL BUSINESS**

Small business was identified as a key factor in the recovery of the Russian economy in the initial stages of the transition. The state programme "Development of Reform and Stabilisation of the Russian Economy" (1993) identified small business as the main driving force of the market reforms as well as the basic instrument for the structural and institutional transformation of the economy. In reality, state support for small business development has been scarce and erratic, denoting the lack of a clear strategy in this field. The programmes of support for small business which have been in force since 1994 have suffered from chronic under-funding in addition to being inadequately implemented. In 1994-5 the federal budget allocated only 0.001% of total expenditure to small business support (CCET, 1998: 57).

Since 1991 small firms have been identified as a distinct target for legal regulation and legislation aimed at small business has been passed at federal and regional levels. The first document contemplating measures for the support of small business in the Russian Federation was the Regulation of the Council of Ministers no. 406 of 18 July 1991 - "On Measures for the Support and the Development of Small Enterprises<sup>5</sup> in the Russian Federation" - which introduced profits tax exemptions, assistance in the supply of materials and machinery, and allowed for accelerated depreciation

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<sup>5</sup> A small enterprise was defined as one with an average of fewer than 200 employees in industry and construction, 100 in science and scientific services, fifty in other branches of the production sphere and fifteen in the non-production sphere and retail trade. Both full-

(double the normal rate) in the first two years of a firm's existence. However, the assistance in the supply has remained only on paper. Even the tax exemptions did not have much effect, since they were frequently ignored by the tax authorities. The Presidential decree no. 1485, dated 30 November 1992, reiterated the concession to small enterprises of tax privileges and ordered the formation of banks and special funds for the promotion of entrepreneurship. These funds were charged with channelling centralised credit financing to small firms engaged in priority sectors (agriculture production and processing, consumer goods production, construction materials production and the construction of housing, social and environmental protection facilities). The Fund for Small Business Support and the Development of Competition, set up as a consequence of the decree of the Government of Russia of 1 April 1993, was subsequently designated as the main vehicle for providing financial support to small business. Initially, it was attached to the Anti-Monopoly Committee, but after less than a year it became an independent organisation with the name of Federal Fund for Small Business Support (hereinafter called the Federal Fund). Even prior to this date, some local governments had already created their own funds for small business support financed by privatisation revenues and/or additional local taxes - e.g., for extracting raw materials (Chepurenko, Avilova and Pripisnov, 1995: 22).

The first official document which spelled out the duties of the ministries and departments of the Federation in the field of small business was issued in mid-1993 (decree no. 446 dated 11 May 1993 - "On Primary Measures for the Development and State Support of Small Enterprises in the Russian Federation") (Tsyganov, 1995: 121). The co-ordination of state policy was entrusted to the Ministry of the Economy. In the Russian state, small business policy falls under the jurisdiction of Ministry of the Economy, the Anti-Monopoly Committee, the Ministry of Finance, the State Property Committee, the Committee for Industrial Policy and the Federal Employment Agency. All six bodies are represented in the Supervisory

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time and part-time employees, as well as contract workers, are included in the figures.

Council of the Federal Fund, but owing to the strong rivalry among them, there has been a duplication of work rather than a co-ordination and reciprocal exchange of information. One example refers to the ten or so draft laws on small business support, containing only marginal differences, which were drafted in 1993. This decree also widened the categories of newly established small enterprises benefiting from total exemption from the profits tax during the first two years of activity. The following sectors were included: food processing and production of medical equipment, medical preparations, items for medical use and equipment for disability rehabilitation. Exemption is granted on condition that earnings from the listed activities exceed 70% of the total revenues of the firm in question. Small enterprises were also entitled to make use of accelerated depreciation during their whole period of existence, rather than just the first two years. In addition, in the field of foreign trade it was decided to allot special export quotas to small businesses.

Some additional tax concessions to small enterprises were conceded by the Presidential decree no. 2270. Small businesses were exempted from the tax on property in the first year, and from the advance payment of the profits tax. Self-employed individuals engaged in entrepreneurial activity were also exempted from the value added tax. Another measure was the reduction of the profits tax by two-thirds for banks and insurance companies which grant at least 50% of their loans or receive more than 50% of their premiums from peasants, collective and state farms and small enterprises (excluding those engaged in wholesale and retail trading)<sup>6</sup>. This concession was, however, modified from 1 January 1996, when the reduction in the profits tax was lowered to 30%, and cancelled a year later (Poltorak, 1997: 5). The Presidential decree also stated that small firms working in priority sectors would benefit from a reduced profits tax rate in the third (25% of the full rate) and fourth years (50% of the full rate) of existence, in addition to the total exemption in the first two years. In order to be entitled to these privileges, the revenues from these activities must represent more than 90%

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<sup>6</sup> It is not clear whether this exclusion also applies to insurance companies.

of the total income in the third and fourth years (70% in the first two years<sup>7</sup>) and the share of the charter capital belonging to state firms must not be higher than 25%. These benefits are not applicable to enterprises that were set up in place of liquidated enterprises and their branches. Enterprises which close down within three years (subsequently increased to five) of their creation, having exploited these tax concessions, are obliged to pay the profits tax in full for the period of existence, but how this measure is to be implemented is not clear. However, these rules are easily circumvented. It is possible to transfer employees and equipment to a new enterprise without formally closing the previous one in order to be entitled to four more years of privileges.

The difficulties faced by small firms in abiding by the tax laws prompted the approval of a simplified accounting method. Firms with up to fifteen employees have been given the opportunity of opting for a simplified system of accounting and taxation (federal law no. 222 of 29 December 1995 "On the Simplified System of Taxation and Accounting for Small Firms") upon acquisition of a patent which can be granted only if the following conditions are satisfied:

- the firm must not have taxes or other payments overdue.
- it must have submitted previous profit and loss accounts within the period prescribed.
- the total revenues during the period of the year to the quarter preceding that in which the request has been forwarded must not be greater than the minimum wage multiplied by 100,000.

In order to obtain the patent an enterprise must apply to the tax inspectorate stating that it qualifies as a small enterprise in accordance with the legislative criteria. The tax inspectorate, upon verification of the documents,

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<sup>7</sup> The law "On the Introduction of Changes and Additions in the Law of the Russian Federation On the Profits Tax of Enterprises and Organisations", which came into force on 1 January 1996 raised from 70% to 90%, even for the first two years, the minimum proportion of revenues coming from priority activities in order to be entitled to tax holidays.

issues a patent which must be renewed every year. For individual entrepreneurs the payment for this tax replaces the payment of the income tax. Firms which choose this system are obliged to pay only a quarterly tax in place of federal and local taxes (payments to extra-budgetary funds, customs duties, taxes on the purchase of auto vehicles and cost of licences are not exempted). Although passed as a federal law its precise implementation is managed by the local tax authority, which has the right to set the price for the patent entitling the firm to use the simplified system, and to apply either a profit rate not higher than 30% (10% must go to the federal budget), or a rate on the total turnover not higher than 10% (3.33% must go to the federal budget), or a combined system depending on the sector of the activity. This law does not apply to producers of products paying excise duties, financial institutions, insurance companies, investment funds, brokers, companies engaged in gambling and entertainment, and specific activities for which the Ministry of Finance has requested a special system of accounting. In practice, the limit of fifteen employees rules out a large percentage of industrial enterprises. Up to the first quarter of 1997 only 53,000 enterprises had opted for this system, as its utilisation has some drawbacks. For example, by opting for this law, a firm loses the profits tax privileges conceded in the first four years of existence. Furthermore, it is not clear how to return to the standard system. The law also does not clarify how a firm with a supplier opting for this system has to deal with the payment of the value added tax. According to the law "On Value Added Tax" the VAT paid by a firm is to be calculated as the difference between the tax paid on purchases and the tax received on sales, but there is no reference to the case in which the supplier is exempt from payment of the VAT.

Despite the various laws aimed at small business promotion in the early transition years, the government was accused by representatives of entrepreneurial associations of at least ignoring, if not hindering, the development of entrepreneurship. Many of the measures contained in the laws designed to promote small business remained unapplied. The tax

concessions to small businesses were frequently ignored by tax authorities (interview with Ioffe, Polyansky, 1996: 29). The total tax burden became very high for small and large enterprises alike, and bank loans became very difficult to obtain. Accounting also became very complicated owing to the enormous number of regulations, whereas under perestroika it was much simpler. Orlov, president of the Academy of Economics, argued that the state policy towards small business is in effect aimed at increasing state revenues and providing financial benefits for state bureaucrats, since the maze of regulations invites bribery (Nelson and Kuzes, 1995a: 136). Kivelidi, the director of the Council on Entrepreneurship, an independent think tank established by a Yeltsin decree, asserted that entrepreneurship seemed for the government only “an abstract idea and even dangerous. It is a threat to their existence” (Nelson and Kuzes, 1995a: 132). According to this line of thought the ruling elite which has taken advantage of privatisation to enrich itself would view with suspicion the appearance of new independent groups and attempt to stifle their development. This interpretation would be supported by the ambiguous policy of the state towards small business which has produced little beyond empty declarations.

Since 1995 a unified system of support for small business has been in operation. This system includes the State Committee for the Support and the Promotion of Entrepreneurship, the Federal Programme of Small Business Support, the Federal Fund for Small Business Support, the Regional Funds for Small Business Support and the Russian Small Business Support Agency. The State Committee for the Support and the Promotion of Entrepreneurship (hereinafter called State Committee) was formed (Presidential decree no. 563 dated 6 June 1995) in order to co-ordinate the activities of the ministries and agencies responsible for developing and regulating small business, and to guarantee the execution of state policy in this field. The main functions of the State Committee are:

- to propose new legislation.
- to draft and implement state policy and a federal programme for small

business.

- to protect the interests of business people and listen to their opinions on different issues.
- to guarantee the effective utilisation of the funds earmarked for the support of small businesses.
- to attract foreign capital by means of agreements with small business bodies in other countries.

In addition it is supposed to provide the following services to small businesses:

- the organisation of training courses and assistance in import-export operations.
- providing information, consultation and financial support for the creation and management of small enterprises.

The Federal Fund is the financial instrument of the State Committee. It has the task of channelling the finances of the federal programme of small business support and taking part in the financing of regional programmes and other projects and initiatives aimed at supporting and promoting entrepreneurship. It can also invest in small firms or in infrastructures designed to promote small business.

The provision of consulting and the organisation of training for entrepreneurs has been entrusted by the State Committee to the Russian Small Business Support Agency. The Agency, initially founded in 1992 by the central government, with the support of the British Know-How Fund, to supply consulting and information services to small businesses, entered into agreement in 1994 also with the TACIS programme to finance jointly the opening of a network of Development Agencies for small and medium-sized enterprises throughout the country. These Agencies are responsible for providing legal advice, marketing, audit and accounting consultation and promoting the use of leasing as a financing instrument for small enterprises. By the beginning of 1998 there were forty-seven such agencies in Russia.

The outlines of state support for small business were established by the federal law no. 88 "On State Support of Entrepreneurship in the Russian Federation" which came into force on 20 June 1995. It indicates the main directions of small business support. Self-employed individuals also come within the scope of this law. The main points of the law are:

- in the first four years of existence a small firm is protected from any change of legislation for the worse. If legislation creates less favourable conditions for a small business than existed at the time of its creation it will not take effect.
- at least 15% of state procurements must be awarded to small firms.
- local authorities are prohibited from demanding additional conditions for the registration of a company beyond those required by federal law.
- the new criteria of definition of small business are stated (see section 3.2). It is expressly declared that these conditions cannot be modified by local authorities.
- the creation of a network of science parks, leasing companies, business incubators and other infrastructures which favour the acquisition and development of modern equipment and technology by small firms is planned.
- assistance is envisaged in foreign trade, in the purchase of modern equipment and technology and in the training and retraining of staff.
- the government is obliged to submit every year to the parliament the Programme of Small Business Support. The parliament and all regions of the Russian Federation are obliged to implement this programme. If a region does not fulfil this requirement it will not receive financing from the Federal Fund.

The first Federal Programme of Small Business Support was approved by the Government of the Russian Federation on 29 April 1994 for the years 1994-95 (decree no. 409 "On Measures for State Support of Small Enterprises in the Russian Federation in 1994-1995"). The programme envisaged a wide range of measures aimed at supporting small businesses in

line with the federal law no. 88 “On State Support...” plus the concession of loans and licences on favourable terms and loan guarantees. The priority areas are the same as already indicated in the decree no. 446 passed in 1993 with in addition a general reference to industrial products and innovation activities. However, there are several gaps in the framework of the law. For example, the procedure by which small businesses can qualify for these loans is not specified. The financing of this programme was guaranteed by the allocation of 5% of the privatisation receipts and some budget financing, while the programme for 1996-97 stated that money could also be raised through the placement of bonds and other sources. Privatisation receipts have, however, turned out to be much lower than forecast. Budget financing was equally scarce. In total 20-25 million roubles (\$4 million<sup>8</sup>) were allocated for the 1994-95 programme, 10% of the sum planned (CCET, 1998: 54); an amount not sufficient to carry out the assigned tasks (Vilenskii and Maevskaia, 1995: 142). The federal programme for 1996-97 adopted in December 1995 received its financing from the budget only in February 1997, which comprised just 35.7% of the planned amount (Vysokov, 1998: 1; Orlov, 1997: 132), in spite of the fact that the planned outlays had already been reduced from 800 to 386 million roubles (Korobkova, 1996: 1). The scarce consideration given to small business in the parliament is emphasised by the fact that, while the planned outlays on this programme were more than halved, funding to other programmes was increased (CCET, 1998: 56). Needless to say, many measures were never realised. Even the guarantees to the German bank Kredit Anstalt fur Wiederaufban<sup>9</sup>, which had made available fifty million marks for the support of small and medium-sized businesses, had to be cancelled. Also, measures which did not require financial backing, such as the reservation of 15% of state orders for small businesses had not been implemented by 1998 (Vysokov, 1998: 1). In any case, given the low payment discipline of the

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<sup>8</sup> Calculated at the average exchange rate in 1997

<sup>9</sup> This loan was to be jointly guaranteed by the Russian and German government. The loans which were to be handed out by the Russian Small Business Bank were planned to amount to up to one million marks with a duration of three years and an interest rate of no more than 15% (Moscow News May 25-29 1996 10) Four areas were designed as the likely beneficiaries of these loans: Moscow, St. Petersburg, Vladimir and Tyumen.

federal budget, this measure does not look very attractive for small businesses. Neither was the concession of licences to small businesses made easier.

Equally unrealised was the Presidential decree of 4 July 1996 "On Priority Measures of Government Support for Small Enterprises in the Russian Federation" which envisaged the transfer of a further 150 million roubles (\$30 million) to the Federal Fund, and investments of the order of 500 million roubles (\$100 million) in highly effective industrial and innovation projects. This act was frozen following the strict fiscal measures approved after the elections of 1996.

Financial support for the small business programme has been progressively scaled down. In 1998 the assignation of 5% of the privatisation receipts was revoked. In the state budget for 1998 no resources were initially earmarked for the development of small business, and only through the influence of the new director of the State Committee were 100 million roubles (\$10 million) finally assigned, but at the end they were not disbursed (Savchenko, 1997; Golubtsov, 1999: 5).

Despite the limited financing the state programme provided, by the beginning of 1996 local programmes had been adopted in most of the Russian regions (Blinov, 1998: 241-247), and Regional Funds set up in more than seventy. There is a group of regions (Moscow, Novgorod and Samara Oblast) which have a well developed structure for the promotion of small business. In another group the programmes have been implemented only from 1995-96 and financing has been low. St. Petersburg can be associated with this second group, while there is a third group of regions such Arkhangelsk, to the north of St. Petersburg, which have set up no structure at all (Predprinimatel' Peterburga, 1998, no.10: 7). In general, there is a tendency towards a decentralisation of responsibility for providing support to small businesses. The resources managed by the Regional Funds increased from 29.2 million roubles (\$32 million) in 1993 to 240 million in

1995 (\$53 million) (Ermakov, 1996: 27), but in the absence of a law dictating the sources of financing of the local funds, these resources are dependent on the will of the local authorities. By law the Federal Fund should give to Regional Funds the same amount of financing allocated by local authorities, but this is not always the case.

In 1996 Federal and Regional Funds financed 2,680 projects for 310 million roubles (\$61 million). However, the lack of accurate control procedures over the activities of the Federal and Local Funds has resulted in countless faults: ineffective allocation of resources, utilisation of excessively complicated procedures of selection of the projects and passivity in attracting additional resources (Ermakov, 1996: 27). It is not surprising, therefore, that the attempts of the Regional Funds at self-sufficiency through rendering paid services met with little success. A TACIS programme aimed at training Regional Funds in implementing an efficient credit mechanism was launched in 1997 to address a lack of expertise in this field. Given both the long period of time it takes to evaluate projects and the small sums they award, these Funds have not proved very popular among Russian entrepreneurs. The applications received have not been numerous, but this is also because these programmes are very little-known among entrepreneurs. According to a survey only 13.9% of entrepreneurs were aware of the existence of the federal programme, 10.1% of the regional programmes and 5.6% of international programmes for small businesses (Avilova and others, 1997: 32).

An audit of the Federal Fund activities was carried out in 1997 uncovering a long list of failings. The Fund did not always follow the correct procedure when it conceded loans. They were often conceded not through open competition, but by the individual decision of the Fund officials, even when proper business plans were lacking. This resulted in a high percentage of defaults. In addition, the Fund overspent for the well-being of its workers by giving out interest free loans and paying more generous travelling allowances than those established by the regulations. It was also found that

one-third of the Regional Funds did not spend money for the designated aims (Khrapova, 1997: 29). In total about 90% of the resources received from the state were not utilised correctly (Sokolovskaia, 1998b: VI). Even the banks did not utilise the resources received for the assigned aims. The bank SBS-Agro gave out loans to small businesses amounting to only nine million roubles out of the 150 billion received from the Federal Fund. The results of the inquiry were revealed in May 1997, but no measures were taken until April 1998, when the accounts of the Fund were frozen and the director was forced to resign. The new director of the State Committee has declared an intention to make the activity of the Fund more transparent. All new agreements will be publicised and past agreements will be reviewed. Loans will be conceded only through open competition. In any case it is planned to leave the concession of loans mostly to banks, while the Fund will provide guarantees to the banks entrusted with the concession of loans (Sokolovskaia, 1998b: VI). Eighty per cent of the resources are planned to be spent jointly with regions. The crisis of August 1998 has, however, thrown the Fund onto the verge of bankruptcy since it had invested its assets in the bank SBS-Agro, which went into receivership, and in the GKO state bonds which were frozen (interview with Khakamada, the director of the State Committee, Ipatova, 1998b: 16). The State Committee was unexpectedly abolished in the autumn of 1998 and its functions were given to the Anti-Monopoly Committee. The new aim of the government is for small business support to be carried out primarily at the local level. For this reason the Russian government has decided to omit all expenditure for small business support from the state budget. Given the ineffectiveness of state support its abolition will have hardly any detrimental effect.

The years from 1995 to 1998 were characterised by an attempt on the part of the federal government to establish a structure geared towards the promotion of small business, which has been shown not to be very effective. This structure has been seen by most entrepreneurs as just another layer of bureaucracy. As before, many of the measures contained in the Presidential decrees as well as in the state programme seem to have been

just recommendations or declarations of intent, having never been realised. Some are so vague (for example, investments in highly effective industrial and innovation projects) that one wonders if there was a clear focus behind them. The fact that some measures have been continuously repeated without being put into practice casts doubts on the seriousness of the government's intentions. A simplification of the tax system would be much more welcome as would easier access to finance and less bureaucratic interference. A step towards the simplification has been the approval of the new law on imputed revenues, which however has been criticised by entrepreneurs because it leaves the setting of the criteria for the determination of revenues in the hands of the local officials, thus giving them another tool of influence (Scimbireva, 1998: 2).

## **2.5. REGULATIONS**

The regulatory regime is probably among the most difficult to manage in the world, even if recently the government has attempted to improve this situation and the number of activities requiring licences has been reduced. Starting and operating a business is much more complicated in Russia than in the leading transition countries. There are no standard procedures and regulations evolve constantly. A vast array of permits is necessary to start a business, and the interference of local bodies with business activity is a frequent occurrence.

Opening a business entails a lengthy process of registration and obtaining various approvals, certification and licences. In total, it is necessary to have permits from about fifty officials (BBC Monitoring ..., 1998, no. 545: WA/4). Registering a business takes an average of 2.7 months in Moscow, but "only" 0.7 months in Warsaw (Schleifer, 1997: 12). To start a firm it is necessary to open a bank account and to register with city authorities, with the tax office, statistical bodies and with the social welfare funds (Pensions, Medical Insurance, Social Security, Employment). Licensing is also a complicated and expensive procedure which is regulated by many

conflicting legal acts. Following a Presidential decree issued in 1994, the number of activities subject to licensing was reduced to eighty-eight, yet the criteria for classifying activities as subject to licensing are unclear, and there are many discrepancies in federal and regional legislation. Certification is also required for a wide range of activities. About 75% of the products sold in Russia are subject to certification (Zakharenko, 1998: 3). The cost of licensing varied from \$750 to \$5,000<sup>10</sup> in 1998, while for registration it was between \$750 and \$2,500, depending on the region, in 1994, and for certification between \$500 and \$2,500 in the same year (CCET, 1998: 51-52). It is clear that the total cost is a strong barrier to entry. Some improvements in this context have, however, recently occurred. In June 1998 a Presidential decree was issued to remove administrative barriers and simplify licensing and certification procedures for private businesses. The decree is a recommendation to administrative bodies to reduce administrative barriers for entrepreneurs, but its effectiveness depends on what measures the government take to fulfil it. A first step was the approval, in 1998, of the law "Licensing Selected Types of Activity" which reduces the number of activities requiring licensing and the cost of licences. This law restricts licence requirements only to activities which can damage the rights, legal interests, morality and health of citizens and rules that the maximum charge for obtaining a licence cannot be more than ten times the minimum wage. It is also envisaged that the number of state bodies licensing businesses will be reduced, as now in addition to the federal ministries there is a large number of local bodies in charge of licensing.

Even during the day to day operations of the firm local bodies regularly interfere. According to a survey conducted in 1996, a shop in Moscow is subject to twice as many inspections as in Warsaw and is twice as likely to be fined (Schleifer, 1997: 12). Eighty-three per cent were fined during the course of the year. Another survey pointed out that a firm is subject to an annual average of three visits by controllers. Seventy per cent of the visits are carried out by just four organisations (fire-safety supervision, the tax

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<sup>10</sup> Calculated at the 1998 exchange rate before the depreciation of the rouble in August

inspectorate, the sanitary station and the police) (IPSSA, 1998: 60). Due to the ambiguity of legislation it is very easy for officials to find an infringement of the law. This continuous interaction with officials frequently requires the payment of bribes. Two-thirds of entrepreneurs are estimated to have been victims of extortion by bureaucrats. For twenty per cent this is a frequent occurrence (OECD, 1998a: 5). On average in Russia small businesses are said to pay at least \$500 a month in bribes. More is paid at the beginning of their activity when the firm is registered. The tremendous level that corruption has reached among state officials is also recognised by senior ministries. The Interior Minister, Kulikov, admitted that he had been unprepared for the level of corruption existing in state bodies, particularly in his own ministry (Varese, 1997: 588).

## **2.6. CRIME**

The great majority of businesses are believed to pay protection money: around 70% according to surveys (CCET, 1998: 24). The rackets are mainly interested in trading companies, rather than industrial firms, as profits are believed to be higher in this sector. In order to gain market intelligence, racketeers are said to have their men in the banks who inform them of the most significant transactions (Blinov, 1996: 41). However, to what extent criminal activity represents a constraint for small businesses is unclear. Even if, according to the surveys carried out, the racket is not considered by businessmen to be among the major problems they face (Chepurenskiy, Avolova and Pripisnov, 1995: 32; Radaev and others, 1995: 56; Voprosy Statistiki, 1995: 57; Leontief Center, 1998: 12), the reason for this seems to be the reluctance of entrepreneurs to speak about the problem. It seems, however, that it is considered much less of a nuisance than state bureaucracy, as racketeers are usually careful not to demand such a large proportion of a company's profits<sup>11</sup> to cause the failure of the firm (unlike tax bodies), and provide a service - protection - that the police are unable to

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1998.

<sup>11</sup> According to one source (Babaeva and Lapina, 1997: 102), this is usually 10-15% of the real profits, not the profits shown in the official accounts, as racketeers use the real

guarantee (Babaeva and Lapina, 1997: 101-102; Zhuravskaya, 1998: 56-7; Blinov, 1996: 41). For this reason they are not always seen as an entirely negative phenomenon. In recent years racketeering has gained some legitimacy with the appearance of more and more legitimate security firms offering this kind of service. This has also the advantage that expenses for protection can be deducted from the taxable profits. The racket is, however, only one part of the criminal world. A survey published in 1996 showed that Russians considered crime to be the second most pressing problem after the price increases in the previous five years. Especially vulnerable are highly placed managers, a great number of whom have been murdered in contract killings. Eighty-three per cent of managers complained of having been subjected to coercion and threats.

## **2.7. SOURCES OF FINANCE**

The lack of capital is even more of a hindrance for the creation of small firms than in Western countries due to the reasons explained in the introduction. The banking system inherited from the previous regime is still ill prepared to meet the financing needs of the private sector. In Russia, lending to the private sector was 10% of GDP in 1997<sup>12</sup>, while in other transition countries such as Poland and Hungary it was almost 40% (Russian Economic Trends, 1998, no. 1: 96), and it is usually short-term. Loans of over a year were until recently almost unobtainable by small firms<sup>13</sup>. Entrepreneurs, therefore, lack the necessary resources to expand micro enterprises into small and medium firms. At the same time interest rates are very high. For example, they ranged from 30% to 70% per year in 1998, before the rouble devaluation, at a time when inflation was at about 10% (Broadman, 1999: 22). For these reasons only a small, although growing, minority of entrepreneurs manage to receive loans from banks. On the other hand, less than half are estimated to have the capability to apply

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accounts of a firm to calculate how much it can pay.

<sup>12</sup> The figure refers to January-November 1997.

<sup>13</sup> As of 1 January 1996 the percentage of long-term loans in the total value of loans in the Russian banking system was 5.7% (IPSSA, 1997b: 20).

for bank loans. Therefore, they tend to rely on informal forms of financing, as only 15-20% of the costs of setting up a firm come from personal savings (CCET, 1998: 22). However, the situation is slowly improving. Various initiatives funded by foreign donors have demonstrated that financing small businesses can be profitable. Even if not all the international programmes have achieved self-sufficiency they can still be considered successful because the proportion of non-returnable loans has been very low and their example has stimulated in the last few years Russian banks in developing small business and micro-lending programmes<sup>14</sup> (Arnold, 1999: 41; IPSSA, 1997b: 21), while before small enterprises could receive loans only from banks working in the context of EBRD and other international programmes. Although the crisis of August 1998 has led to a sharp fall in the concession of loans by the EBRD and to a rise in arrears for foreign currency loans this is due to the sharp depreciation of the rouble which made foreign currency loans three times dearer in the space of a month. The amount of loans conceded was, however, planned to be back to almost the pre-crisis levels by the end of 1999<sup>15</sup> (Merkushev, 1999: 17).

## **2.8. FACTORS WHICH HAVE LED TO A SLOWER DEVELOPMENT OF SMALL BUSINESS IN RUSSIA COMPARED TO THE LEADING TRANSITION COUNTRIES: AN ANALYSIS**

The post-communist transition has been marked by recovery following a few years of depression in some East European countries (here called the leading transition countries: Poland, Hungary and the Czech Republic) and

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<sup>14</sup> IPSSA (Institute for Private Sector Development and Strategic Analysis) conducted in 1997 a research entitled "Comparative study of financial services available to micro and small business". It (IPSSA, 1997b: 21) found that most banks positively evaluated the prospect of granting loans to small businesses: 45.4% planned to increase the volume of loans to small businesses; 42.5% planned to maintain the current level; and only 10.1% planned to reduce it.

<sup>15</sup> The EBRD provides small loans of up to \$125,000 with maturities of up to a maximum of three years and micro credits of between \$100 and \$30,000 for an initial period of 6-12 months. Thirty thousands such loans had been disbursed by October 1999. The loans are given to small companies in the production and service sector. Companies must demonstrate both their ability to repay the loans and their sound management practices. Arrears on micro loans were 1% of the total before August 1998, but went up after the crisis and by October 1999 were 3.5%. Arrears on small loans were 2.8% before August 1998 and 9% in October 1999 (Merkushev, 1999: 17).

a protracted depression in the former Soviet republics and the Eastern states close to them geographically. The reasons underlying the different economic trends do not differ from the reasons for the differing performance of the small business sector. Small business development can be generally seen as an indicator of success in the economic transition. The best performing countries have witnessed a strong development of the small business sector. Poland had 2,000,000 small firms in 1997<sup>16</sup>, accounting for 30% of its GDP and Hungary more than 500,000 with ten million inhabitants, while Kazakhstan had just 52,000, accounting for 7.7% of its GDP (OECD, 1998b: 3) and Ukraine had 136,000 registered private firms in 1998 (plus 3,000 co-operatives), a number which has been practically stable since 1994-5 (Smallbone and Welter, 1999: 14), indicating that, as in Russia, small business has stopped growing.

It has been argued that the countries which implemented the reforms more swiftly were the first to recover, while the slower countries to reform have fared worse. However, this explanation is only partially convincing and does not explain why in some countries the advocated reforms had much less effect than in others. In Russia there was a belief that simply laying down free market legislation and privatising state assets would quickly lead to a well-functioning market economy and a swift rise in living standards. One of the plans at the time of perestroika was recommending the switch from a command system to a market economy in 500 days. However, several years have passed and Russia is still not a proper functioning market economy. What has changed is that, despite the extensive privatisation carried out, industrial output has fallen by more than half. In Poland the industrial sector has performed much better, despite having been privatised much less. Not only has the new private sector been more vibrant, but former state firms have been able to restructure more than in Russia, where

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<sup>16</sup> The definition of small firm is not, however, uniform across all the transition countries. Statistical bodies in Poland define a small firm as having fewer than six employees and a medium-scale firm as one with 6-50 employees, so the terms small and medium firms broadly correspond to the Russian definition of small firms. Poland's figure probably refers to small and medium-sized companies, as defined by Polish statistical bodies.

the beneficial effects of privatisation are not very clear<sup>17</sup>.

The absence of a stable macroeconomic environment - especially the high inflation experienced by Russia for several years and the budget deficits - has been used to explain the continuous economic depression. It is known that stability makes planning easier for firms, especially with regard to the timing of investment, expansion and innovations. High rates of inflation have a deleterious effect on manufacturing activities deterring long-term investments, while encouraging entrepreneurs to engage in activities with high turnover and a high profit margin (Smallbone and Welter, 1999: 9). However, even when Russia achieved a reasonable degree of stability in 1996-1997 and 1998 up to the August crisis, with inflation down to almost single-digit figures, it did not experience any recovery<sup>18</sup>, but only a decrease in the rate of output fall, and small business did not grow. Considering how much output had fallen previously, this cannot be regarded as a real achievement.

The lack of an effective system of state support for small business and the limited financing provided to small businesses has been cited as another reason for the lack of small business growth. Entrepreneurs have had to rely only on savings and borrowings from family and friends to finance the creation of their enterprises. The reform process has been based on achieving macroeconomic targets and has given little attention to small business. However, the situation was not much different in the leading

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<sup>17</sup> Pinto, Belka and Krajewski (1993: 253) argue that also state industries in Poland have been able to carry out significant restructuring. On the impact of privatisation in Russia there is disagreement among scholars. Jones (1998: 96), on the basis of econometric work, concluded that the impact of privatisation in St. Petersburg was quite weak. Sanches-Andres (1998: 252) found that the results of privatisation in the defence industry in terms of production adjustment were small. Ickes and Ryterman (as quoted by Rutland, 1996: 32) also did not find any consistent difference in performance between privatised and state firms. Earle and Estrin (as quoted by Schleifer, 1997: 7) and Earle and Rose (1996: 11) found instead that privatised firms restructured much faster than state firms. A reason for the alleged slow restructuring process in Russian privatised firms might be the slower rate of managerial turnover. According to two different surveys in the Czech Republic 70% of the privatised companies replaced most of their management between 1992 and 1995, whereas in Russia only 32% of the companies privatised in 1992-1993 had carried out changes in top management by 1995-1996 (Russian Economic Trends, 1998, no. 2: 50).

<sup>18</sup> A growth rate of 0.8% was registered in 1997, but negative growth would have been recorded except for the increase of 2% in the share of the unofficial economy in GDP.

transition countries. None of them had a coherent policy for SME development, at least in the first half of the 1990s and financing for small businesses was scarce. As explained in section 1.4 the legal system was hardly conducive to growth, even if in the leading transition countries it compared favourably with Russia (EBRD, 1997: 17-81).

We can, therefore, affirm that small business does not require a focused policy to develop, but has thrived in some transition countries despite several constraints. Once economic freedom is granted, people try to exploit the new opportunities and this gives rise to a new class of property owners, whose importance in the economy tends to grow year after year.

In order to understand why Russia has under-performed we have, therefore, to take other factors into consideration, although some explanations are not fully convincing such as:

- political instability
- diffusion of the protection rackets
- low social capital.

Political instability does not seem to be relevant for domestic entrepreneurs, otherwise we should have witnessed a burst of entrepreneurship following Yeltsin's re-election in 1996; the re-election was much more important for foreign investors, who were encouraged by this to invest more in Russia. The danger of a return to a communist regime and a re-nationalisation of private property is not really contemplated by domestic entrepreneurs. The evidence on protection rackets being a serious constraint is blurred. More small businesses pay protection money than their Polish or Czech counterparts (Shleifer, 1997: 11), but as mentioned before there is no clear indication as to whether they represent one of the major constraints due to the reluctance of the entrepreneurs to discuss the matter. Low social capital could be adduced as an explanation for the poor performance of the economy. Putnam (1993: 181) has shown that the stock of social capital can explain why some countries or regions perform better than others.

Social capital can be interpreted as the “existence of networks which link individuals or groups to information or credit or as a set of trusting social relationships which facilitate the development of productive activities”(O’Brien and others, 1996: 4). However, Schleifer (1997: 17), on the basis of data from the World Value Survey, cannot find any substantial difference between Russia and the other East European countries in regard to the levels of trust in the society. Regarding the development of networks in Eastern Europe and Russia a comparative analysis is, instead, lacking. Russian entrepreneurs tend to be rather isolated<sup>19</sup>. Few are members of any association and relationships among them are scarce, but how the situation differs in other East European countries is unclear.

Whether or not the supposedly lower development of supporting networks and the higher level of crime might have played a role in restraining entrepreneurship, the more convincing factors which differentiate Russia and the other former Soviet countries from the East European countries in this context are:

- The lack of historical roots and the longer period of communism in Russia compared with the other Eastern bloc countries. Private entrepreneurship in Russia has a weak tradition, as even before the revolution the principal entrepreneur was the state. In addition, seventy years of communist dictatorship have resulted in a lack of business experience, while where the communist influence has been lower and memories of the market economy were fresher entrepreneurship took root more easily. The Czech Republic, Poland and Hungary had a tradition of developed entrepreneurship before the advent of communism and some entrepreneurial activity was allowed to develop in Hungary and Poland during the communist period. Experience from other countries suggests that a number of generations are usually required before an effective entrepreneurial culture takes root, although some

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<sup>19</sup> Webster and Charap (1993: 57) found in 1992 that entrepreneurs in St. Petersburg tended to be isolated from each other, from the state sector and from the outside world. This fact has also been emphasised by Pechatnikov, the director of a Business Development

countries, such as Japan and South Korea, have successfully fostered entrepreneurship through a series of supportive policies. As far as Russia is concerned, even if nowadays creating a small firm is extremely popular<sup>20</sup> (CCET, 1998: 93) and entrepreneurs are held in high regard fewer people are likely to have the resources to start an activity than in the other East European countries, the failure rate is very high (see section 3.2) and the number of firms growing large is lower<sup>21</sup>. This may be the result of the adverse conditions a small business has to deal with, but it is also a consequence of a lack of business skills, especially of primary market analysis. Russian entrepreneurs have high qualifications, but feel themselves in need of management and business knowledge (Babaeva and Lapina, 1997: 27-28). By contrast, entrepreneurs in the leading transition countries are believed to have higher business skills as a result of the fresher memories of a market economy and the more frequent contacts they had with Western firms in the communist period.

- The existence of larger bureaucratic obstacles (see section 2.5). It is more difficult to open a business due to the lack of a standard procedure of registration, licensing and certification with clear rules and the regulations a business has to comply with in its activity are very convoluted, especially for manufacturing enterprises. The evaluation of the national and local government detected in surveys has been negative in Russia as well as in the other former Soviet countries. Just 12-13% of the firms surveyed by Smallbone and Welter (1999: 10) in Moldova, Belarus and the Ukraine thought that governments were favourably inclined towards small businesses.
- Greater corruption which has a strong impact on businesses, almost all of which are obliged to bribe repetitively. A business is subjected to

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Centre, in a recent article in a St. Petersburg newspaper (Belenkova, 1999: 2).

<sup>20</sup> As explained in section 1.5, even if creating a firm is very popular what is not clear is how many actually feel ready to start their own business.

<sup>21</sup> For example, output in new firms in Poland was growing much faster than in Russia according to World Bank surveys carried out in 1993 in Poland and 1994 in Russia (Richter and Schaffer, 1996: 12).

countless inspections and the attitude of officials is often to extract as much money as possible from the private sector. According to the EBRD the burden is especially heavy for small firms (particularly start-ups) in the former Soviet Union (Akin, 1999: 2). The state has shown little willingness to intervene. A tremendous amount of corruption has followed the communist downfall. The level of corruption has been highest in the states where the old nomenklatura was not wiped out, such as the former Soviet Union. Data referring to 1993 show that in Russia 83% of the political elite were former communist party members compared with 30% in Poland (Shleifer, 1997: 21). Russia is rated among the most corrupt countries in the world. It came 47th out of fifty-four countries analysed by the University of Gottingen (Business Eastern Europe, 1996: 1). Similar conclusions have been reached by the Economist Intelligence Unit and by the DRI/McGraw Hill Risk Service (EBRD, 1997: 37). The culture of misappropriation of public funds is a tradition in Russia which seventy years of state socialism have helped to establish firmly. Such a culture is unlikely to disappear quickly, but it has been kept more in check in the leading transition countries, some of which, according to the University of Gottingen's report, had a worse corruption record than Russia in the 1980s and nowadays have a much lower rating. Corruption has an adverse impact on economic development. Several studies have shown that it reduces investment, both domestic and foreign, and, as a result, stifles the growth rate (Tanzi, 1998: 585-586). High levels of corruption also have a detrimental effect on tax revenues, undermining the capacity of the state to provide support to low income strata of the population, which in turn creates more political instability.

- The absence of the notion of the law seems to characterise worse performing countries, while in the leading transition countries there is more respect for legislation, due to more advanced legal traditions. A market economy functions if there is a widespread acceptance of the rules and these rules can be enforced when there is a breach, but the idea

that a law incorporates the acceptance of the people under its rule is alien to Russia. The lack of respect for the law in Russia has caused legislative chaos, effectively making it impossible to work and abide by the law. In spite of promises to simplify legislation, little improvement can be detected. The approval of the first part of the tax code, intended to simplify the tax system, has been diluted by subsequent legislation. Ukraine has the same problems as Russia: excessive and overlapping legislation, a high level of taxation and a large number of government bodies which can inspect private firms while businessmen are often unaware of the specific requirements of a given state agency (Pidluska, 1998: 1).

- Taxation is also much higher in Russia and more confusing because of the legislative chaos. The tax burden is especially high for manufacturing firms.
- Large industrial enterprises are in worse condition in Russia than in the leading transition countries. Taxation coupled with the high utility prices, exacerbated by the fact that Russian industry is highly energy intensive, leaves manufacturing firms with few resources to make investments and to carry on their normal business. Fraudulent practices have also played a part in starving firms of funds. One way this occurs is through transferring revenues from the sale of a firm's most valuable assets as well as of its products straight into the personal foreign accounts of the firms' managers<sup>22</sup>. The payment crisis which has arisen means that in 1997 an enterprise received on average less than 20% of its sale revenues in cash, rather than in non-monetary forms of payment. The rest was composed of veksel (promissory notes), mutual off-sets and barter operations (Russian Economic Trends, 1998, no. 1: 92). The share of revenues represented by cash has subsequently risen to 35% in

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<sup>22</sup> As mentioned before, the tax office estimates that more than half of the non-payments to utility firms are in effect paid into foreign accounts of the managers of these enterprises (Current Digest of the Post-Soviet Press, 1996, no. 41: 6). How widespread this phenomenon is in other Russian enterprises is hard to evaluate, but there are frequent references in the press.

August 1998, and to 49% in February 1999, nevertheless less than half (Russian Economic Trends, May 1999: 6). Adding to all this the depressed level of demand, it is, therefore, very hard for enterprises to prosper. In other East European countries the role of large enterprises has been instrumental in fostering the expansion of small enterprise networks; but in Russia the poor economic condition of most large enterprises has meant that a major sales outlet for small businesses is almost absent. While, for example, in Slovenia many small industrial firms were suppliers of large establishments (Bartlett and Prasnikar, 1995: 99), this option was scarcely available in Russia. Prospering small firms are, as a rule, oriented to the final consumer.

- The general situation of instability in the country affects small businesses. An example is the collapse of a number of major private banks following the crisis of August 1998, which resulted in serious losses by depositors and paralysed economic activity for a while, as these banks suspended their operations. Many depositors lost their life savings, as had happened in 1992 during the hyperinflation, since bank deposits were not indexed to inflation. Entrepreneurs complain of working without knowing what can happen the following day. A firm's accounts can be frozen by tax inspectors without any warning; a firm can be fined for an amount several times greater than the original error, even if it is inadvertent; money can be lost due to fraudulent operations carried out by fictitious firms against which current legislation offers limited protection; and so on.
- Even if in all transition countries start-ups have been overwhelmingly financed by the entrepreneurs' own funds, more loans have generally been available to existing businesses in Eastern Europe, as Russia's banking sector is still very small by international standards - much smaller than in the leading transition countries - and a very high proportion of domestic credit goes to the government and public enterprises (Russian Economic Trends, October 1997: V-VI). In

addition, interest rates are higher in Russia<sup>23</sup>. Only 15% of small businesses in Russia have received bank credits in recent years (Broadman, 1999: 22) and in the Ukraine, Moldova and Belarus just 3%. In these three countries only 11% of small businesses had received external finance of any sort (Smallbone and Welter, 1999: 9).

- The high income inequality which has arisen since the downfall of communism has meant that a middle class with the resources to start businesses has not emerged. High income inequality hampers economic growth not only because fewer people are able to start a business, but also because it reduces investment in human capital as the poor are unable to afford education and training. Income inequality has risen in all the transition countries, but the rise has been very small in Central Europe (which now has a level close to the OECD average), more pronounced in the Balkans and in Baltic states, and very striking in Russia and the Ukraine (Milanovic, 1998: 71). In Russia the Gini coefficient, a general measure of inequality, increased from 0.26 in 1991 to 0.41 in 1994, according to state statistics, but independent bodies evaluate it to be higher<sup>24</sup>. The Russian Centre for Public Opinion Research puts it at 0.46 in 1994 (Silverman and Yanowitch, 1997: 27) and the RLMS<sup>25</sup> at 0.48 in 1995, one of the highest figures in the world (Klugman and Braithwaite, 1998: 46). Economic reforms have greatly benefited a rather limited share of the population. Connections have allowed them to gain ownership of former state property and amass substantial wealth. While the communist nomenklatura was wiped out in

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<sup>23</sup> In Hungary real interest rates were about 10% in 1996 (Oakey, 1997: 38), and in Slovenia 10-15% in the mid-1990s (Marot, 1997: 57), but in Russia only loans in dollars are available at these rates, while interest rates on loans in roubles went from 30% to 70% per year in 1998 before the August crisis. In this period inflation was below 10% (Broadman, 1999: 22). The average cost of a one-year loan from a commercial bank for an enterprise was 39% in August 1997 (Russian Economic Trends, October 1997: V).

<sup>24</sup> The official data are based on the Family Budget Survey, which has been subjected to a certain amount of criticism as being scarcely representative of the total population (Klugman and Braithwaite, 1998: 41-42).

<sup>25</sup> RLMS stands for Russian Longitudinal Monitoring Survey, a household survey carried out by Goskomstat with technical and financial assistance from the World Bank and USAID.

the leading transition countries, this did not happen in Russia and the Ukraine. The wealthy have indulged in conspicuous consumption which has benefited importers of expensive foreign goods and in the main cities also the construction business, but they have not been inclined to invest in the domestic economy, preferring to send their wealth abroad. A large amount of money has left the country before and since the downfall of communism.

As Russians slowly adapt to the new market practices, a process of industrial restructuring is bound to take place, as the better managed enterprises expand. This is already taking place in some sectors (food, construction materials, pharmaceuticals), where domestic firms are winning market shares. The speed of this expansions hinges on how Russia will deal with the above-mentioned factors. Some improvements can be detected in the procedures for opening a business (new legislation has been approved) and in the availability of loans, but in regard to other matters there have been no changes in the second half of the 1990s: the same as in the first half. The political will to address them is lacking, and the poor performance in the December 1999 parliamentary election of the parties which claim to support the entrepreneurial class (Yabloko and Otchestvo) does not bode well for the future, but much depends on the next President given his extensive powers. Will the new president try to rein in corruption and give a cleaner image which can serve as an example to the country, will it be willing to simplify taxation and legislation? Will its economic policy be biased towards dispensing favours to connected figures? Another outstanding issue is how long will it take before small business takes a firm root also outside the major cities. Whole areas of Russia, which were dominated by state firms and farms now practically bankrupt, have little economic activity with the population surviving by growing its own food. The prerequisites for the growth of new enterprises are absent, and a way out of the current depression will take much longer in such places.

## 2.9. CONCLUSION

Russia is still far from having a well-functioning market economy. The Russian tax system favours consumption over investment and is a serious impediment to growth. According to the Heritage Foundation, it is ranked 117th out of a list of 150 in an index of economic freedom, which evaluates how countries score on a list of ten factors, including trade and taxation policy, level of privatisation, monetary policy, property rights, antitrust regulation and the size of the unofficial economy (Varese, 1997: 579). The business environment is rather hostile with a high incidence of arbitrary interference and corruption, especially among public officials. The constraints emphasised in this chapter affect all businesses, but they have an especially strongly negative impact on small business because of the disproportionate burden of complying with convoluted legislation which is impossible to abide by. The complications in tax legislation mean that a great amount of time is needed to deal with a never-ending set of problems with the constant risk of incurring heavy tax penalties and high costs in administrative personnel. The taxation system has regularly come at the top of the lists of factors constraining small business in the various surveys, not only because of the sheer amount of taxes, but also for the behaviour of tax inspectors, often characterised by the absence of a sense of fairness. The incomplete legislative framework is often ranked in second place (CCET, 1998: 22). The flight of some foreign investors, even after investing a considerable amount of money<sup>26</sup>, highlights the difficulties of the Russian business environment. The simplification of the tax system with the approval of the new tax code could make life easier, but this is unlikely to be a panacea as the successive amendments could erode the beneficial effects of the new code. Protection rackets, which have arisen because of the weakness of legislation, are also believed to place a high burden on small firms, but are not necessarily seen as a negative phenomenon because

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<sup>26</sup> To give two examples: IBM closed its factory in Zelenograd in March 1996 just two years after it was opened, one of the reasons being that the agreement with federal authorities to exempt components and parts from import duties was not respected; and Philipps sold to the regional government its factory in Voronezh for one rouble after having carried out considerable investments (Matveeva, 1999: 16).

they fill a gap that the state cannot. Evidence suggests that, unlike the state, these rackets seem concerned not to suffocate business activities with excessive demands.

As far as the state policy towards small business is concerned in the post-communist period there has been a considerable discrepancy between words and actions. Little of what has been approved has been implemented. This has resulted in a lack of trust towards the state which is not viewed as credible. Ultimately, only the first programme of small business support received funding, but even the limited resources provided were largely ineffective. No real commitment has been shown by the state in improving business conditions for small firms. Conditions have become even worse in some areas (for example, taxation and availability of finance) compared with the late Soviet period. Some have claimed it was a specific policy to keep economic power in the hands of the former masters, but it is also related to the general chaotic state of the Russian economy. The efficacy of the tax concessions for small businesses is questionable, as they are open to abuse. Firms may re-register under another name once the period of tax benefits has expired. It would be more appropriate to simplify taxation and reduce the tax burden.

The reasons why small business growth was slower in Russia compared with the leading transition countries can be attributed to the less developed business skills, which are due to historical reasons. Another reason is that as summarised by Nellis (1999: 18): “Poor outcomes have been more pronounced where the post-transition state structures have been weak and fractured, allowing parts of the government to be captured by groups whose major objective is to use the state to legitimate or mask their acquisition of wealth”.

The actual development level of the small business sector in Russia and St. Petersburg will be analysed in the next chapter trying to assess whether the official statistics give the true picture taking into account the other sources of information we have.

### **3. MEASURING SMALL BUSINESS ACTIVITY**

#### **INTRODUCTION**

Any research on small business in the transition countries has to examine closely the methodology used to produce statistics, given the ongoing process of adapting the system of statistical accounting from the old method to the new. For this reason, statistical methods may not be adequate to capture the new private sector which is emerging in these countries. The methods of collecting statistics are analysed first. Then I will comment on the figures on small business in Russia and in St. Petersburg, although the frequent changes in the method of calculation make it difficult to carry out such an analysis. I will critically assess the reliability of different data on small business, the available evidence on the origins of small businesses, on creation and failure rates, and the changes in the composition of this sector throughout the 1990s. Evidence on whether the process of stagnation is a real phenomenon or not is also assessed in addition to the results of surveys on the small business sector, which may offer some explanation on how small businesses are faring. In looking at St. Petersburg these wider issues will be discussed in a local context.

#### **3.1. THE METHODOLOGY USED BY STATISTICAL BODIES TO ANALYSE SMALL BUSINESS**

In the Soviet period statistical observation covered all enterprises, which had to report on thousands of indicators: not only financial data, but also production and technical indicators had to be provided on a regular basis in order to check plan fulfilment. Information on small enterprises belonging to the private sector has been collected by the State Committee on Statistics (Goskomstat) since the birth of the first co-operatives in 1987, but initially there was no single body specialised in collecting this information. Data on small business were collected separately by each branch department using their own specific methods. The different statistical forms used for the

various sectors did not allow for an overall picture of small business, as most of the indicators varied from sector to sector (Alimova and other, 1998: 29). Only some general indicators - absolute numbers, wage levels, employment structure - on all small enterprises were calculated by the Department of Labour and Wages. In 1993 a special department was finally established, charged among other things with providing data on small enterprises. At the end of 1995 this task was given to the newly created Department for Enterprise Statistics.

Because of several changes in the methodology which occurred during these years, data on small business<sup>1</sup> are hardly comparable. The methodologies used have been the following:

- from 1987 to 1990 the total number of co-operatives was collected.
- in 1991-1992 only newly created small enterprises and co-operatives were covered by statistical observations. State-owned firms were not taken into consideration as in the previous period.
- from 1993 to 1995 all small enterprises were included regardless of their ownership.
- from 1996 only enterprises considered small according to the definitions stated in the state programme of support have been included. In conformity with this law, farmers and individual entrepreneurs who are self-employed are also included in the small business sector, but, not being required to submit statistical reports, are not included in the official statistics.

The definitions stated in the state programme are:

- the share of charter capital belonging to legal entities which are not small businesses, to state, religious, social and charitable organisations and other foundations must be lower than 25%.
- a maximum of 100 employees in industry and construction (previously by law it was 200), sixty in science and scientific services (previously

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<sup>1</sup> Russian statistical bodies identify small, but not medium enterprises, which are grouped together with large firms.

100), fifty in public catering and other non-production spheres (previously fifteen) and thirty in retail trade and consumer services (previously fifteen)<sup>2</sup>.

The definitions stated in Russian law are not comparable with those normally used in most countries where there is a given limit to the number of employees regardless of the firm's activity and no limitation concerning the ownership of the charter capital. These definitions exclude a great number of firms considering that about 68-72% of the total number of firms in Russia are considered small businesses (IPSSA, 1998: 26), while small and medium enterprises (SMEs) make up between 99% and 99.8% of all enterprises in the OECD countries<sup>3</sup> (OECD, 1996a: 20). Notwithstanding the change of methodology from 1992 to 1993 the trend in the official figures altered little, while the change in 1996 has especially affected - in a negative direction - the figures concerning the total number of small business workers. Less clear are the effects on the total number of firms. According to a study carried out by the Institute for Private Sector Development and Strategic Analysis (1997: 53), the lowering of the limit concerning the maximum number of workers in industry and construction in 1996 has excluded approximately 8% of the small industrial and construction enterprises previously included in the statistics. The new criteria have also excluded enterprises where more than 25% of the charter capital is owned by other enterprises which are not small businesses. On the other hand, the limit on employees in the other categories which in 1996 accounted for 63% of the total number of firms was doubled or tripled and this has resulted in a significant number of additional establishments falling within the scope of the law. Having said this, it is clearly difficult to judge the effect of the new limits on the total number of small businesses counted by Goskomstat.

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<sup>2</sup> The limit on the number of workers is calculated taking into consideration the average number of employees during the year including employees in branches and representatives' offices, contract workers and part-time workers (calculated on a *pro-rata* basis).

<sup>3</sup> Although the SME definition is larger, including firms with up to 500 employees, almost all the firms in this category have less than 100 employees.

While statistical observation was conducted along sectoral lines in the Soviet period, a new form of statistical observation (form N 1 MI) came into use in 1993 (resolution of the Goskomstat dated 19 January 1993) which had to be compiled quarterly by all small enterprises with a maximum number of workers varying from thirty to 200 depending on the industrial sector. Small industrial enterprises were defined by Goskomstat as having:

- up to thirty workers in food and printing industries
- up to fifty workers in flour-mills, wood, paper, construction materials and light industries
- up to 100 in electric power, fuel and reprocessing of ferrous and non-ferrous metals
- up to 200 in machine building, ferrous and non-ferrous metallurgy and other industrial sectors.

The statistical form N 1 MI also applied to firms with fewer than fifty employees in construction and transport, thirty in science and agriculture, fifteen in retail, wholesale and public catering and ten in other activities. The parameters for industrial firms were changed for 1994 and 1995. A unified ceiling of fifty workers was defined regardless of the sector. As Goskomstat until 1995 used criteria for defining a small business which did not comply with the law, data on small enterprises not included within these parameters had to be extracted from the regular statistical forms, which varied according to the sector, and then, in order to obtain a complete picture of small business added to the figures regarding the enterprises covered in the form N 1 MI. The form N 1 MI contained forty-two indicators for all sectors of the economy, which were reduced to eighteen in 1995, while, for example, industrial enterprises not falling within the scope of this form had to report on up to 6,500 indicators.

The most significant indicators of the form N 1 MI are:

- full-time workers

- part-time workers
- contract workers
- consumption fund (with wage fund separated)
- total output (including VAT)
- gross profits / losses
- main assets
- capital investments.

This form did not contain any information on ownership shares concerning firms of mixed property. For this reason, until 1996 a clear definition of the private sector did not exist in the statistical accounts and therefore statistics on the share of the private sector in the GDP referring to these years are not accurate. Usually a firm is considered private if the state share is less than 50%, but in the Goskomstat classification of the forms of property such a distinction did not exist. Among the different classifications used there are the terms “mixed Russian ownership” and “mixed ownership with Russian and foreign participation”, which refer to companies with state shares regardless of the magnitude of this share. The amount of charter capital belonging to all the founders was included among the indicators of the new form of statistical observation “Information on the basic indicators of financial-economic activity of small enterprises” adopted in 1996 for all firms considered small by law (Ermilova, 1998: 4). Therefore, from 1996 sectoral forms no longer applied to small firms.

In fact, the reforms in statistical accounting undertaken by Goskomstat to bring it into conformity with standard international methods entail a progressive phasing out of the sectoral forms. Yet, in 1997 there were still 241 forms of statistical accounting at the federal level and 348 departmental forms, making a total of 589, but their number was slowly decreasing (by 5% in 1996 and 11% in 1997). Of the 241 federal forms (IPSSA, 1997a: 139):

- twenty-four are filled in by extra-budgetary funds belonging to federal and local bodies of executive power.

- 180 are filled in by firms and organisations, depending on their sector of activity.
- thirty-seven are multi-sectoral, covering firms in different economic branches. Two of these contain basic indicators respectively for small firms and for joint-ventures and foreign firms.

From the beginning of 1998, Goskomstat has organised a new method of collection and processing of the basic statistical information. Four new forms of statistical observation were introduced: “Information on the production and dispatch of goods and services”, “Information on investments”, “Information on the financial situation of organisations” and “Information on the number of workers, wages and turnover of workers”. These forms apply to all enterprises, regardless of the sector they belong to, except for the third form, which does not apply to small enterprises. Therefore, it will be possible to compare data on enterprises working in different sectors. For large and medium firms the observation will be complete, while for small firms it will be by sampling.

Given the rapid increase in the number of economic entities in existence, selective observations of small enterprises began to be carried out quarterly in the second quarter of 1995, but only for those falling into the scope of the form N 1 MI. For these firms complete observations continued, however, to take place once in a year. The share of small enterprises included in the surveys varied in 1996 from 10% to 20% of the total, depending on the absolute number of enterprises in a given region. At the end of each year sample data are compared with data resulting from the complete observation and the data for the last quarter are adjusted so the average of the four quarterly surveys corresponds with the figure for the whole year. For this reason, data in the fourth quarter may differ considerably from the previous quarters. Thus, for example, the figures regarding the average number of workers in industry, the retail trade and other commercial activities in the fourth quarter of 1994 differ substantially from the figures from the first three quarters (IPSSA, 1997a: 56).

Due to the low response rate - in 1994, for example, almost half of the enterprises avoided statistical reporting obligations - in order to fill in the gaps, since 1994 Goskomstat has also used data from the State Register of Enterprises and Organisations and tax statistics<sup>4</sup> for recalculations, even if the information provided by these bodies is not always reliable. These in 1994, on average, accounted for 30% of data collected, with variations from 20% to 60% in the different regions and the following proportions in different sectors (CCET, 1998: 135): industry 36.5%, construction 28.4%, retail trade 59.5%, other consumer services 50.7%, science and scientific services 48% and in other sectors less than 25% (Alimova and others, 1998: 30). Following the introduction of the rule which requires statistical reporting as a necessary precondition for reporting accounts to tax bodies, the rate of reply has, however, improved (CCET, 1998: 135).

The problem with data from the State Register is that it contains a significant proportion of inactive enterprises; and a great many of the active firms do not produce the items declared in their statute. Some of these may be "shadow" enterprises set up for the purpose of tax avoidance (Gibb, 1995: 3). In order to fool tax authorities several shell firms are registered with municipal authorities, but not with the tax authorities or the pension fund. They may not be detected by tax authorities for a certain period of time, but, not having registered with the tax authorities, cannot open a bank account or become visible. Another reason for registering two or three firms in place of one is that, in cases where a firm has to close down following a tax inspection, the entrepreneur may continue to operate using another firm. According to the director of the Register of Enterprises of St. Petersburg, approximately 30% of firms are set up only to carry out one or two swindling operations. The compulsory re-registration of all firms, with deadlines varying from mid-1995 to mid-1999, because of the introduction of the new Civil Code which altered the definitions of certain types of

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<sup>4</sup> Each firm must provide some sort of data to the statistical office, tax authorities, pension funds, employment funds, registration bodies and banks, but they are often deliberately inaccurate, either to avoid tax obligations and for the not ill-founded fear that information

enterprises should have eliminated such inactive firms, but the compliance with this regulation has been low (Kontorovitch, 1998: 9). Because many inoperative firms are not liquidated, the share of registered enterprises which are estimated not to be operational is constantly increasing.

As most of the firms give answers in such a way as not to disclose their real profits, in the industrial sector, for example, Goskomstat matches data received from enterprises with indicators such as freight transport volumes, tax offices data and the results of its own market surveys in order to assess the real production levels (Aris, 1997: 19). However, as declared by Gimpelson and Lippoldt (1999: 511) that the methodology of adjustment has never been made public and it is unclear to what extent these figures reflect reality. Goskomstat has progressively increased its estimate of the size of the grey economy in recent years from 18% of GDP to 20%, then to 22-23% in 1996 and 25% in 1997 (Boiko, 1997: 9; Khanin, 1997: 7), while at the end of the communist era this coefficient was just 4%<sup>5</sup> (Economist, 1995: 107). The sectors in which in 1996 unofficial sales had the lowest share of total sales were considered by Goskomstat to be industry - 11%, transport and communications - 9%, and construction - 8%, while the highest share was in retail trade - 63% (Aris, 1997: 19).

The official estimates of the informal economy are, however, probably too low. The same Goskomstat admits that it may be as high as 30% of GDP (Shul'ga, 1997: 50). A 1996 survey of industrial and commercial firms taken in equal numbers suggested that the average share of the unofficial sales was about 29% of the total revenues by the admission of the directors of the enterprises surveyed (Simachev, 1997: 21), while scholars' estimates for the whole economy vary between 30% and 40% (Kaufmann and Kaliberda, 1996 : 98-99; Johnson, McMillan and Woodruff, 1999: 3; EBRD, 1997: 74). Concerning small businesses an extensive survey on small business carried out between 1992 and 1994 by the Institute for Private Sector Development and Strategic Analysis (Voprosy Statistiki,

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might end up in criminal hands.

1995: 39), found that about a third of the output was unofficial. In this survey, the share of the unofficial economy was found to be quite uniform at 30-35% of the total in the different sectors considered (industry, construction, commerce, public catering and other services). These figures are very close to the previous survey which covered large and small firms alike. There are some estimates which point to an even greater share accounted for by the grey economy in the small business sector<sup>6</sup>, but most of the studies carried out suggest that the grey economy is between 30% and 40% of the turnover (studies reported by IPSSA, 1998: 106).

The figures provided by Goskomstat regarding the total number of small firms refer only to active enterprises without foreign participation. Firms with foreign participation are covered by a different form and are not included in the statistics among small firms. Data on the number of active firms are based on the surveys Goskomstat carries out. On the basis of the share of firms found to be inactive in the survey-based observations, the local statistical bodies estimate the total number of registered small firms which are operative (Kontorovich, 1998: 6).

In the opinion of the Institute for Private Sector Development and Strategic Analysis (1997a: 58), one of the major research centres on small business in Russia, the current statistical methods give only an approximate indication of the trend of small business development, rather than the true size of this sector. Statistical data are sometimes controversial and the method of recalculation used is not clear. Goskomstat's statisticians themselves admit that the system of collecting and analysing statistical data does not allow them to follow with due precision developments in the private sector of the Russian economy (Alimova and others, 1998: 26-37). On occasions national and regional offices of Goskomstat have provided two different

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<sup>5</sup> This share is added to the legal economy in the calculation of the GDP.

<sup>6</sup> The organisers of the second congress of entrepreneurs affirmed that two-thirds of the turnover is unofficial (Preprinimatel' Peterburga, 1999, no. 26: 2). Similarly, Khakamada, the former head of the State Committee for the Support and the Promotion of Entrepreneurship, estimates that 70% of the turnover is not officially stated in the books (AmCham News, 1999: 2).

sets of data on small business in the same region, as data sent to the headquarters in Moscow are recalculated using their own methods. For example, in the Tomsk region the number of small enterprises was estimated to be 4,356 in October 1995 by the regional branch of Goskomstat, while the official statistics of the Russian Federation indicate figures of 5,673 and 5,176 in June and December 1995 respectively (Radaev, 1997: 67). The difference of 15-25%, depending on the month referred to, is quite significant.

### **3.2. MEASURING SMALL BUSINESS ACTIVITY IN RUSSIA**

As mentioned in the previous section, figures relating to small businesses should be taken with caution because information originating from state statistics, from bodies that register enterprises and from the tax service is very incomplete. Data on the number of firms is believed to represent the most reliable indicator concerning small business, while sales and profits are severely underreported in the official balance sheets. Sutherland (1997: 10) argues that employment is underreported as well, but Alimova (interview), a leading expert in small business, did not agree. The total wage fund is, instead, more likely to be underreported as it heavily taxed<sup>7</sup>. However, as explained below even data on the number of small firms are questionable.

According to official statistics, the growth in small businesses was very rapid up to 1993, after which a stagnation, characterised by moderate variations, has set in. The number of small enterprises in operation rose from 268,000 in 1991 to 865,000 in 1993 and remained at more or less the same level until 1998<sup>8</sup> (Shulus, 1996: 70; Goskomstat, 1996e: 688; Goskomstat, 1998c: 8; Mazurova, 1999: 3).

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<sup>7</sup> About half of the salary is, on average, paid unofficially according to the organisers of the second congress of entrepreneurs (Predprinimatel' Peterburga, 1999, no. 26: 2).

<sup>8</sup> Although as mentioned before in 1991-1992 Goskomstat included only newly created small enterprises and co-operatives in the statistics these data refer to all enterprises considered small by law at that time.

The puzzling fact is that the total number of economic units increased significantly in the same period, when, officially, small businesses declined or increased marginally. The number of enterprises rose by 56% in 1994, 16% in 1995, 11% in 1996, 10% in 1997, and 6% in 1998 (see table 3.1.). Because of this, the share of small enterprises counted by Goskomstat in the total economic units decreased from 69.5% in 1993 to 29.9% in 1998. In 1992 this percentage was as high as 92%. If in 1996 the divergence in the trend could in theory be attributed to the change in the criteria (although the effect of this is not clear, as explained in the previous section), the reason for the divergence in the other years is unknown. It is implausible that it is due to the creation of new large firms. It could be that these newly set up enterprises are partly owned by large firms and, therefore, do not qualify for the definition of small business or that the proportion of inactive small firms has increased dramatically since 1994, when according to Goskomstat they accounted for 28-32% of the total number of firms (Predprinimatel'stvo v Rossii, 1998: 54). Alimova shares this last explanation, affirming that most of the firms which cease activity are not liquidated as liquidation procedures are very cumbersome. Due to the poor enforcement of bankruptcy procedures many might survive in an embryonic state. In theory, keeping a firm open should entail the payment of a tax, but it is very difficult for tax officials to detect these firms. These points, therefore, require further research.

TABLE 3.1.  
Number of small businesses and total number of firms

	1991	1992	1993	1994	1995	1996	1997	1998
(A) Small businesses	266.7	560.0	865.0	896.9	877.3	841.7	861.1	868.0
(B) Total								
no. of firms	314.2	609.0	1,244.9	1,946.3	2,249.5	2,504.5	2,727.1	2,901.2
% of A to B	84.9	92.0	69.5	46.1	39.0	33.8	31.6	29.9

The figures are listed in thousands and refer to the end of each year.

Sources for the total number of firms: Goskomstat, 1998d: 342 and Statisticheskoe Obozrenie, 1999, no. 3: 19.

Simple observation of enterprise numbers cannot explain the underlying cause of change. The increase in the early nineties may be the result of more new business start-ups or of longer survival times, while the

subsequent stall may have been caused by a variation in one of these two phenomena. Unfortunately, no data are available on this matter. The little available evidence suggests that the survival rate is lower than in Western Europe, but it does not clarify whether it has lengthened or shortened during the course of the 1990s. Only one-third of the newly set up enterprises are believed to survive in Russia after the first year in the late 1990s - an unusually low share, if this data is reliable (Chamber of Commerce of the Russian Federation, 1998c: 1), - compared with a share varying from 76% to 92% in the Western European countries (Der Horst, 1996: 279). Similarly, the impression of a Western consultant working with small businesses is that 80% of firms fail in the first two years of existence (Holtmann, 1997: 8). However, it must be kept in mind that many companies in Russia are created just to realise a few operations, remaining active only for a short time. Confirmation of the extremely high failure rate in Russia seems to be evident in government statistics indicating that just 5% of small businesses registered in 1991 were still operational in late 1997 (Polonsky, 1998: 527). However, these data are not very reliable because some firms have never been operational and some may have re-registered. Basing an analysis of survival rates on business registers, therefore, gives inaccurate results.

Nor do we know how much of the increase in the early 1990s is to be attributed to the breaking up of large enterprises, rather than to the creation of new firms from scratch and how many of the existing businesses are new firms rather than privatised units. According to a large survey carried out in 1992-1994, about one-third of private small enterprises were privatised state firms or spin-offs, 12% former co-operatives and 56% newly set-up firms (Voprosy Statistiki, 1995: 55), but by the late 1990s the picture must have completely changed in favour of new firms considering, the widespread creation of new firms and the high mortality rate of small firms (which might, however, be much larger for newly set up firms).

Overall the growth has been much less vibrant than in the leading transition countries. The hopes of the mid-1990s that 2.5-3.5 million small businesses would be in existence in a few years have not materialised (OECD, 1997: 38). Poland, with 38 million inhabitants, had two million SMEs in 1997 (OECD, 1998a: 3) and Hungary more than 500,000 with ten million inhabitants (Paradis and Rubin De Cervin, 1998: 20). The only exception refers to self-employed workers, the number of whom, in the initial years of transition, grew faster in Russia than in Poland, but this can be explained by the fact that their number was initially much higher in Poland than in Russia. In Poland there were 1,100,000 sole proprietorships in 1990, while in Russia in 1992 there were a quarter of a million, which became 878,000 in 1993 and 2,689,300 in 1997, but for the tax authority their number is still larger: 3.5 million in the first half of 1997 (Piskotin, 1997: 47). Ioffe (President of the Russian Association for the Development of Small Business) goes as far as saying that their real number is close to ten million<sup>9</sup> (Delovaia Moskva Segodnia, 1998: 2). This, according to Ivanova (1998: 29), is a possible indication that many have preferred to be self-employed rather than setting up their own firm because of the easier registration procedures and fewer tax difficulties. In reality, according to RLMS<sup>10</sup> data referring to 1996, two-thirds of these work only on a casual basis. Their median income was just two-thirds of the subsistence minimum (Clarke, 1998: 79).

Between 1991 and 1995, full-time employment in small businesses increased from 5.4 million to nine million and self-employed workers rose by at least two million. Due to the change in the criteria, the number of full-time employees fell to 6.2 million in 1996<sup>11</sup> and has remained at the same level up to the end of 1998 (Mazurova, 1999: 6). Adding also contract and

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<sup>9</sup> He does not specify on which basis this figure is calculated. For example, it is not clear whether he includes shuttle traders and those who sell their goods in the street.

<sup>10</sup> Russian Longitudinal Monitoring Survey

<sup>11</sup> The changes in the criteria are likely to have reduced the number of small business workers, as the categories for which the limit was reduced represented 60% of full-time employment in small business in 1995. In addition, the introduction of limitations in the charter capital has excluded an unknown number of firms, thereby further reducing employment in the small business sector.

part-time workers the total in 1998 was 7.4 million<sup>12</sup>. Because of the drop in small business employment, its share of total employment has fallen from 20.7% in 1995 to 12.9% in 1996 (Russian SME Resource Centre, 1998a: 5) and 12.5%<sup>13</sup> in 1997 (Goskomstat, 1998c: 7). The output of small firms<sup>14</sup> grew by more than one-third between 1991 and 1996, while output in medium and large enterprises decreased by more than one-half (OECD, 1997: 31), but the growth must have been confined to the early nineties, since the share of small business in GDP is estimated to have remained stable at about 10-12% in 1994 and 1995 and to have fallen to 7% in 1996 due to change in the criteria. (Martyanov, 1996: 159; Vilenskii, 1996: 30; Voprosy Statistiki, 1996, no. 11: 29; IPSSA, 1998: 46).

Contrary to official statistics other sources give a much more positive picture of this sector. Babaeva and Lapina (1997: 21) estimate the total number of small business employees at twenty million in 1995, that is to say one-third of the labour force, including those who are officially employed in state firms or unemployed, but who are really engaged in small business activity instead. According to data from a survey carried out in five Russian cities, employment in new private enterprises grew from 0.6% of the total employment in 1987 to 5% in 1993, 12.9% in 1996 and 15.7% in 1998 (see table 3.2. on page 116). What is puzzling is that growth became more consistent after 1994 when officially the small business sector stopped growing. Half of the new private firms surveyed had been set up in the last three years. The same survey, using a different questionnaire indicated that the share of new private firms in total employment was 18.4%<sup>15</sup> in 1998, or 20.6%, including secondary employment, which is

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<sup>12</sup> According to the Federal Employment Service 10-12% of workers had at least two jobs in 1994 (Clarke, 1998: 55).

<sup>13</sup> These figures are calculated by adding to the number of full-time and contract workers the number of part-time workers, considering the time effectively worked.

<sup>14</sup> The OECD refers to small businesses (both Russian and joint-ventures), whereas official data do not include the latter.

<sup>15</sup> The questionnaire on work history has not been adjusted to take into account secondary employment. As explained by the authors (Clarke and Kabalina, 1999: 442), "The figures for 1998 (work history questionnaire) differ from those derived from the individual questionnaires above for a number of reasons: the work history question was a single question, while the sectoral attribution above is based on analysis of several questions;

mostly unregistered. Also adding self-employment it would be 22.5% (Clarke and Kabalina, 1999: 429-433). The percentage varies around 25% and 30% in the large and relatively prosperous cities covered by the survey and between 15% and 20% in smaller cities. As one would expect, new businesses are heavily concentrated in trade and private services, which account for the majority of the employment, while industry accounts for just 10%. Their estimate is that the share of the new private sector in the total GDP is between 15% and 20%, although they admit that it is a generalisation with little analytical value<sup>16</sup>. Even larger shares are estimated in other studies, although there is a question mark over their reliability. The market share of the new Russian firms is estimated to have increased from 18% in 1995 to 33.4% in 1997 by a study conducted by a consulting firm (Tirone Corporation, 1998: 58), but whether this research is trustworthy or not is uncertain<sup>17</sup>. Johnson, Kaufmann and Shleifer estimated the new private sector to account for 23% of GDP in the former Soviet Union as early as 1995, compared with 42% in Eastern Europe, but the method they used raises some doubts according to the EBRD, which considered their findings more useful in showing the trend in this sector, rather than its size<sup>18</sup> (EBRD, 1997: 10).

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around 400 people had left or changed their jobs between the 1 January and the date of the survey, and the latter data includes a number of people, particularly pensioners, who completed the non-workers' questionnaire but turned out to be still working."

<sup>16</sup> They consider that such "a generalisation has little analytical value since it obscures the diversity of conditions between different regions and different types of population centre" (Clarke and Kabalina, 1999: 434). This estimate is based on the fact that the main polling organisation in Russia - VTsIOM - shows a difference of five percentage points between those employed in the new private sector in large cities and in the country as whole. They evidently consider the higher share to be more reliable than that indicated in their survey on work history.

<sup>17</sup> Reading the book one does not get the impression of a careful study. For example, in the table indicating the market share of formerly state-owned and new Russian firms the respective shares are transposed (Tirone Corporation, 1998: 58).

<sup>18</sup> Their estimate of the new private sector is carried out by subtracting the share of the initial private sector from the GDP's share of the total private sector in 1995 and making adjustments for the impact of privatisation.

TABLE 3.2.

## Sectoral distribution of employment

	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998
State/ privatised	99.2	98.7	98.2	97.4	96.0	95.0	93.7	91.3	89.1	86.7	84.1	80.7
New	0.6	1.0	1.2	1.9	2.9	3.9	5.0	6.9	8.8	10.7	12.9	15.7
Private												
Self	0.2	0.4	0.5	0.7	1.0	1.1	1.3	1.8	2.1	2.6	3.0	3.6
Employed												
No. of replies	3774	4703	4815	4965	5091	5203	5292	5384	5494	5596	5719	5867

1 January each year. Work history data from household survey (in %).

Source: Clarke and Kabalina, 1999: 434

So, are Goskomstat data seriously underestimating the size of the small business sector? Why is the dynamism of new businesses not reflected in its figures? The reason might be due to three factors:

- the increasing contribution of new private firms is partly offset by an analogous downsizing of privatised enterprises. Privatised firms might reduce personnel, having been over-staffed when they were privatised, or many might cease activity altogether. There are no official data on small businesses classified by the origins of the firm, and even surveys scarcely cover this area. Looking at the sectoral composition of small business in industry, it seems clear that much is made up of privatised companies or spin-offs, as explained later. On downsizing we have some evidence from surveys, but it is too limited to allow us to reach any kind of conclusion<sup>19</sup>.
- an increasing number of small business workers escape detection by statistical authorities through not being registered. According to the organisers of the second congress of entrepreneurs, 50% of small firms in Russia are not registered (*Predprinimatel' Peterburga*, 1999, no. 26: 2), but there is no indication whether this phenomenon has grown or not.

<sup>19</sup> A survey conducted between 1992 and 1994 by IPSSA is the only one that distinguishes newly created firms from privatised ones. The economic situation of the two differ only marginally (*Voprosy Statistiki*, 1995: 58), while the results of the few surveys on new firms conducted since 1994 differ substantially from those considering all kinds of firms (see chapter six). However, even if privatised firms are faring no worse than the new ones, they might still be reducing their personnel. Glisin and Rogachevskaja (1998: 25-33-36) found that more firms in industry, construction and retail trade were planning a reduction of their employees than an increase. At least half of the surveyed firms were privatised firms. It is impossible to give the proportion of newly created firms because firms which changed owners were grouped together with the newly created firms.

- some of these firms have become so large that they no longer qualify as small businesses. A breakdown per number of employees is provided by Clarke and Kabalina, but not a breakdown by number of employees and by sector. Therefore, it is not possible to say how many do not fit the definition of small business. It can only be assumed that larger firms mainly consists of industrial and construction companies where the limits are higher (100 employees), but this is only an assumption. On the basis of this, by a rough estimate, about one-quarter do not fit the definition. Excluding these and also those self-employed<sup>20</sup> which are not counted officially among small business employees the share of the new private sector fitting the definition would be between 10% and 14% of the workforce.

This would mean that privatised enterprises would account for a minimal share of employment in this sector, as the small business share of total employment indicated in official statistics was 12.5% in 1998. At least, in industry former state firms seem to account for half of the employment (this would make 1% of total employment). However, having to rely only on conjectures without having more precise data we cannot provide a definitive answer to the above-mentioned questions, even if on the basis of these figures the fact that employment levels have been hovering around the same level since 1993<sup>21</sup> seems to be highly dubious. Therefore, there are reasons to believe that the small business contribution in official statistics has not been fully captured, even if the extent is unknown. Considering the low development stage as compared to the leading transition countries and advanced Western economies, it is presumed that this trend is going to continue.

The dynamism of the new private sector has hardly been discussed in the available literature. Almost all refer to the official small business data, occasionally commenting on the reasons which have led to the stall since

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<sup>20</sup> The share of self-employment has been considered at 1% as this is more or less the share detected in Clarke and Kabalina's survey in the smaller cities where the share of the new private sector is estimated to be equivalent to the national average.

1994. Vilenskii (1996: 36) has suggested that the stagnation indicated in the official statistics can be in part explained by the compulsory re-registration in 1994 and 1995 of firms originally created under the Soviet regime and then of some categories of firms following the introduction of the civil code in 1995. As some of these firms were inoperative, they were liquidated, resulting in a reduction of the total number; however, as Goskomstat data refer to active firms only, this should not have had any effect. The near-completion of privatisation by the end of 1994 cannot be mentioned as one of the reasons of the stagnation as between 1993 and 1995 state firms were included in the statistics and in any case the total number of privatised firms between 1992 and 1995 - approximately 122,000 enterprises, including medium and large ones - was one-fourth of the increase of small businesses in this period. Kontorevitch (1998: 14) attributes the current stagnation in part to the exhaustion of the process of spin-offs from large state firms which led to a strong growth of small businesses in the early 1990s. Once transferring resources from state to private enterprises was made more difficult, seemingly after 1993, small business creation declined. This process, however, mostly involved industrial firms, which have always accounted for about one-seventh of the total number of small firms: therefore this explanation is not sufficient. It is possible that a worsening tax and regulatory climate may have resulted in a higher mortality rate of small firms. High taxes have been regularly mentioned by entrepreneurs as the main problem experienced since the early 1990s, but it is not clear if this problem has worsened over the years. Other problems, such as the hostility of local authorities, are believed to have improved (Delovaia Moskva Segodnia, 1997: 4). According to Benini (1998: 28), small businesses in Russia are supply-driven and do not respond to market signals because of the high segmentation and enclosure of the domestic market and because they suffer from a lack of a clear market analysis for the identification of niche markets. This would explain the initial boom in small business creation and the subsequent stall as these firms could not survive long. The available evidence suggests a high

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<sup>21</sup> As explained before the decrease in 1996 is due to the change in the criteria.

turnover of firms. However, in the light of the recent data on the new private sector we can presuppose that Russia seems to be following the same path as the leading transition countries, where development has been an organic process; although for the reasons explained in chapter one and two, this process is slower than in these countries.

The low output per full-time worker - slightly more than \$6,000 per year in 1997 - indicates the low development stage reached by most of these small concerns. Even considering that real output might be larger by as much as 30-40%, the figure is still very low. It was higher in communications (\$15,000), material supplies (\$11,000) and trade and public catering (\$9,500), while in industry it was equivalent to the overall average (Russian SME Resource Centre, 1998c: 3/1).

In 1997, the highest percentages of workers employed by small business were in construction (39.3%), trade and public catering (35.2%) and science (35.9%). The percentages in industry (12.3%) and finance and insurance (8.3%) were close to the overall average (12.9%), while the shares of small businesses in transport (5.2%), health care (2.7%) and education, culture and art (1.2%) were very low (Russian SME Resource Centre, 1998a: 4). In agriculture it was 3.5% in 1996, but for reasons which are unclear there are no figures for the other years. The division of the huge state farms into smaller units owned by single farmers is clearly proceeding very slowly. The development of entrepreneurship continues to be restricted in the agricultural sector also due to the fact that legislation allowing the sale of agricultural land has not yet been approved in the parliament (EBRD, 1998a: 195). A few regions have, however, recently approved legislation permitting the free sale of land in their regions (EBRD, 1998a: 186). From the following table what is noticeable are the large shifts in the percentage of branches such as science, which is not justified by the employment trends in small scientific firms. The only explanation would be that the number of people employed in this sector varies widely from one year to another which is unconvincing.

TABLE 3.3

Share of workers employed by small businesses in each of the following sectors\*

SECTOR	31/12/94	31/12/95	31/12/96	31/12/97
Industry	13.1%	19.4%	11.3%	12.3%
Agriculture			3.5%	
Transport	5.5%	6.6%	5.2%	5.2%
Construction	78.0%	64.3%	35.9%	39.3%
Trade and catering			35.7%	35.2%
Health care, physical culture and social security	4.1%	4.0%	2.2%	2.7%
Education, culture and art	2.7%	3.3%	2.0%	1.2%
Science and scientific services	51.1%	43.8%	29.2%	35.9%
Finance and insurance			9.95%	8.3%
<b>Total</b>	<b>22.7%</b>	<b>20.7%</b>	<b>12.9%</b>	<b>13.2%</b>

\* The figures regarding the total differ slightly from those provided by Goskomstat. For some unknown reasons some years in a few sectors are left blank.

Source: Russian SME Resource Centre, 1998b: 1.

The structure of the small business sector is overwhelmingly private. While in 1991 just one-third of small enterprises were privately owned<sup>22</sup>, and in 1993 two-thirds (CCET, 1998: 32) private firms accounted for 84.2% of the total in 1994 and 1995 increasing to 90.5% in 1996, because of the exclusion of state and municipal firms, as well as enterprises where the share of capital owned by non-small-business entities is higher than 25%. Mainly for the same reason, the share of small business workers employed by private firms increased from 72.4% in 1994 to 85.6% in July 1997. The change has been particularly marked in industry – from 58% to 81.2% - and in agriculture – from 53% to 84.9% (Russian SME Resource Centre, 1998a: 4).

The composition of the small business sector has changed little during the 1990s. The proportion of small enterprises engaged in trade and public catering<sup>23</sup> has varied between 43% and 49% of the total number of small

<sup>22</sup> It is not specified which categories of enterprise are considered privately owned. Are co-operatives and lease holds included in these figures?

<sup>23</sup> Enterprises belonging to this category are engaged in retail trade (43% of the total number of firms in this category in 1995), wholesale trade (39%), intermediary services for the purchase and sale of consumer goods (more than 14%) and public catering (2.5%) (Voprosy Statistiki, 1996, no. 7: 64). Instead, according to Malinin (1996: 10) intermediary services for the purchase and sale of goods are included in the category “general commercial activity for the functioning of the market”, so it is not clear into which official category intermediary services fall. Malinin’s category also includes

businesses, while the figure for small industrial firms has hovered around 14-15% except in 1992 and 1993 and the figure for small scientific enterprises peaked at 7.5% in 1993 and progressively decreased to less than 5% in 1998. More significant have been the variations in employment, but this has been to a great extent the result of variations in the criteria concerning the number of workers. The share of industry and construction combined fell from almost 60% of the total in 1995 to a little less than 50% in 1996, while trade and catering have increased their share from 25% to 30%. Small firms in industry and construction are usually larger - eleven and twelve full-time workers on average in 1996 respectively -, while trade and catering firms employ half that number. Scientific firms are even smaller, but have the highest proportion of contract and part-time workers. These are often academics who divide their time between their university and the firm. In terms of output, trade and catering had a share higher than their employment share in July 1997 accounting for 36%, while industry (22.4%) and construction (21%) have a lower share. Various surveys have shown that small businesses are engaged in several activities, although the basic activity accounted for an average of 89.2% of their output in 1997 (Russian SME Resource Centre, 1998d: 1). Manufacturing firms are more likely to diversify into trade than vice-versa (Voprosy Statistiki, 1995: 28).

In industry, small firms accounted for 8% of output in 1994 and 1995 (Voprosy Statistiki, 1996, no. 7: 65; IPSSA, 1998: 46). As a comparison, in Hungary in 1993 (the same number of years after the downfall of communism) small private enterprises provided 14.5% of industrial output (Borish and Noel, 1996: 35), while in Poland new private enterprises (presumably small businesses) provided 22% of the industrial output as early as 1992 (Russian Economic Trends, April 1997: V). In 1995 more than a third of small industrial firms in Russia were involved in machine building and metal working, 17% in light industry, 12% in wood and paper and 10% in food processing. These sectors accounted for 26%, 16%, 13%

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intermediary services for the purchase and sale of shares and foreign currencies, plus marketing, advertisement, consulting and auditing services.

and 19% respectively of those working full-time for small industrial firms (Voprosy Statistiki, 1996, no. 7: 65). These percentages changed little in the two following years (Goskomstat, 1998c: 25). The sectoral composition is clearly influenced by planners' emphasis on heavy industry. This should be an indicator that a great deal of industrial small enterprises are either privatised or spin-offs from larger units, as one would expect low capital-intensive sectors such as light industry, building materials and food to develop faster than sectors such as machine building. In effect, more than half of the industrial employment in Clarke and Kabalina's survey (1999: 438) on the new private sector is in light industry or production of consumer goods although they include also spin-offs in their definition of the new private sector.

According to official statistics, small businesses were more profitable than the other firms in 1996, accounting for a quarter of total profits (Russian SME Resource Centre, 1998e: 2). However, data on profits are far from reliable due to the widespread practice of minimising taxable profits. They are also exporting more, since they account for 20% of Russia's exports, as declared by the director of the State Committee (Khakamada, 1). Fewer small enterprises - 20% - were loss-making than enterprises in general - 56% - in 1996, but there was a great variation between different regions. In the Jewish autonomous region, 60% of small firms were loss-making, in the region of Sakhalin 59% and in the Republic of Buriatia 50%, compared with only 4% in Tatar Republic and 6% in St. Petersburg (Chamber of Commerce of the Russian Federation, 1997: 2). Surveys, on their part, have given contradictory results on the status of small businesses. Some have pointed to a worsening environment for small businesses, while others painted a less depressing picture. In general, industrial small enterprises seem to be the category faring worst among small businesses. The OECD reported that surveys carried out in 1995 and 1996 found entrepreneurs increasingly frustrated and pessimistic (OECD, 1997: 136). Glisin and Rogachevskaja (1998: 34) found, instead, small retailers quite optimistic in 1997 - 50% described their financial situation as satisfactory - in contrast to

managers of small industrial and construction firms. A survey carried out in selected Russian regions (Avilova and others, 1997: 5) in the framework of a Tacis programme in January 1997 pointed to an aggravation of sales and mutual non-payment problems. Instead, the annual survey of the Centre for Economic Conditions found positive developments, at least among retailers, while construction and industrial companies, as a rule, survive only because of the enthusiasm of the owners. The diminution of the cash flow and the difficulties in attracting finances mean that only a minority of small industrial enterprises are able to make investments (Vasil'chuk, 1997: II). A subsequent survey of small industrial enterprises by the same Centre revealed an even worse financial situation for this kind of firms. The main factors restraining their growth were a lack of working capital (in 75% of firms), high taxes (65%) and low demand (53%). Especially problematic is lack of payment by clients, which was indicated by 80% of the managers surveyed as one of the main problems, a considerably higher share than in previous surveys (Deikin, 1998: II).

What repercussions did the crisis have on the small business sector? What little credit had previously been available mainly through international programmes dried up, many importers of foreign goods were put out of business (including a great number of shuttle traders), and services catering largely for the new middle class suffered a dramatic fall in demand as the middle class had been hit hardest by the crisis. The effects of the crisis on the different categories of small businesses are, however, not very clear. We do not have much evidence as at the time of writing there is almost no research on small business covering the post-crisis period and the data are unavailable for the period after 1998. For this reason it is difficult to gauge its long-term effects. This aspect is beyond the scope of this work, which covers only the period up to 1998. It seems that firms in the aftermath of the crisis have cut down costs by reducing the number of contract and part-time workers, while retaining their full-time employees. In fact, the total number of full-time employees working for small businesses has barely changed, while the reduction amounts to 14% among all workers, inclusive

of part-time and contract employees. While services are believed to have suffered the most from the crisis and industry to have benefited from it, statistical data on all the categories of small business workers point out that the number of people employed in services remained stable, while manufacturing employment has fallen by 17% and construction even more by 27% (Mazurova, 1999: 6). There has also been a reduction in investment, but the difference is not very significant (-3.5%) and cannot allow us to conclude that the financial situation of small firms has worsened (Ministry of the Russian Federation for anti-Monopoly Policy and Support of Entrepreneurship, 1999: 23).

### **3.3. MEASURING SMALL BUSINESS ACTIVITY IN ST. PETERSBURG**

St. Petersburg has witnessed a continuous and, by Russian standards, exceptional growth in small businesses in contrast to the general situation in Russia where the number of small businesses stalled from 1994 onwards. In St. Petersburg the number of small businesses grew by over 1100% between 1992 and 1998, while in Russia the increase was a mere 50% and threefold if we consider also the previous year. Even after the August 1998 crisis St. Petersburg entrepreneurs were found to be the most optimistic, as almost half did not forecast any reduction in output (Leontief Center, 1998: 10). In 1997 the city surpassed Moscow regarding the concentration of small firms in relation to the population, which reached twenty-two for every 1,000 city residents, compared with 21.2 in Moscow, while the average in Russia is 5.6. The average size of small firms in St. Petersburg is, however, among the lowest in Russia, just five full-time employees in 1998 compared with a national average of seven, and this explains why in terms of employment St. Petersburg still lags behind Moscow.

However, figures about small business in St. Petersburg are as contradictory, if not more contradictory than for the rest of Russia. There was a very big difference in the early 1990s between the data provided by

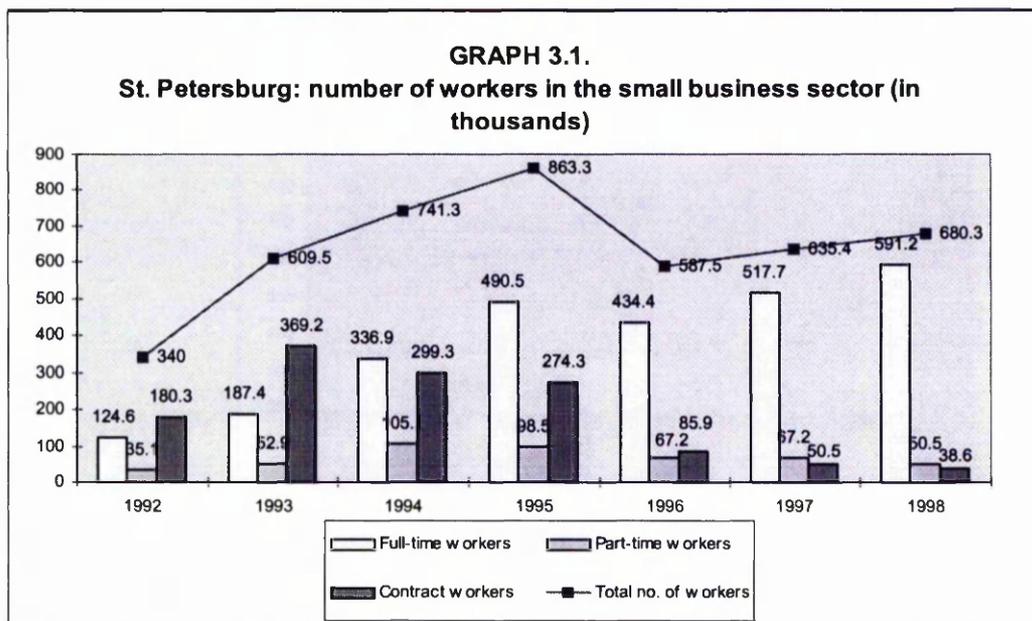
tax authorities and the Goskomstat data which consider only active firms; a difference which has progressively decreased year after year. Goskomstat considered the number of active small firms to be just 9,697 out of the 51,400 firms counted by tax bodies (18.9%) in 1992, 22,695 out of 84,600 (26.8%) in 1993, 57,072 out of 88,000 (64.9%) in 1994 and 68,379 out of 110,000 (62%) in 1995. Data from registration bodies are instead more in line with the small business data, but in any case Goskomstat data referring to the early nineties seem to be an underestimation, as these would give a figure which is obviously too low. In 1992 St. Petersburg accounted for just 1.7% of all small enterprises in Russia with 3.3% of the Russian population, while in 1998 the corresponding share was 13%. Such a low level in 1992 is clearly absurd as small business is bound to be more developed in big cities and there is no objective reason why small business should lag so far behind in St. Petersburg in 1992. What is especially puzzling is the extremely low number of trade and public catering firms. Their concentration in relation to the population was one-fifth of the Russian average in 1992, but by 1998 it was four times bigger. Different privatisation policies cannot explain this as small privatised firms represent a negligible percentage of the whole number of firms. The total number of firms privatised in the city amounted to 3,962 between 1992 and 1996. The fact that more than two-thirds of all businesses are included in the small business statistics in 1997 - twice as much as in Russia - might indicate that figures on St. Petersburg have been overestimated compared with the standard procedure of calculating the number of small businesses in Russia. In the other Russian regions, including Moscow, the percentage resembles more or less the national average. Only in St. Petersburg is the percentage so much higher than the national average. Is it a sign that more small businesses which cease activity are liquidated or that fewer shadow firms are created in St. Petersburg compared with Russia? No data exist on this matter, neither could any of the people interviewed (including the person in charge for small business statistics in the St. Petersburg office of Goskomstat) give an answer. Data reported by Kabakov and Koshparmak (1997: 41), pointing out that 20% of the registered firms in St. Petersburg

were inactive in 1996 are the only clue which seems to suggest that in the St. Petersburg's register of enterprises the proportion of inactive firms is much lower than in Russia.

Small business growth can be better evaluated by analysing employment data. The share of small business (considering only those employed full-time) in the total number of people employed has grown from 5.5% in 1992 to 22.3% in 1997 and 25.5% in 1998 (Leontief Center, 1999: 10), double the comparable share for Russia in 1997 - 12.5%. In addition, there are part-time and contract workers who made up 13% of the total workforce in small business by the end of 1998, while at the start of the decade in 1990, 1991 and 1992 they accounted for between 60% and 64% (Goskomstat, 1992: 2). There has been a big reduction especially in the number of contract workers, which in 1993 numbered twice as many as full-time workers, but have since kept decreasing so that in 1998 the proportion was one contract worker for every fifteen full-time employees in the small business sector. In 1998 the total number of contract workers was 38,600 compared with 369,183 in 1993. The decrease in the number of contract workers is according to the Leontief Center<sup>24</sup> (1998: 11) attributable to the strong reduction in state financing for industry, construction and science where these were mostly employed. However, the reduction of contract workers has been across the board and has been more than counterbalanced by an increase of full-time employees. It is thus probable that after a time these people have been recruited on a permanent basis.

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<sup>24</sup> The Leontief Center is the most important research centre in the economic field in St. Petersburg. It was set up by the local administration and publishes various literature together with the local administration such as the Budget of St. Petersburg, the Strategic Plan, etc.



The rise in the number of full-time employees in the small business sector in St. Petersburg was eightfold between 1991 and 1998, while in Russia the difference was only around 15%. The pace of increase was slightly faster in Russia in 1992, but from then on St. Petersburg steamed ahead. Considering the period between 1994 and 1998 we have a reduction of 30% in Russia, while in St. Petersburg there was an increase of 72%. Only in 1996 did small business employment decrease in the city, but this seems to be just a consequence of the change in the criteria used, as the number of small firms posted a strong increase (+29%) in that year. However, taking into account the other categories of workers, the growth appears less remarkable, even if still significant. The total number of workers employed by small businesses doubled between 1992 and 1998. If we consider also contract workers the share of small business in total employment would be 27% in 1998 - still much lower than in Moscow, where the analogous percentage was 39%<sup>25</sup> - and including part-time workers 29% (Goskomstat, 1998d: 174-350). However, taking all part-time workers into account is not correct as only a proportion of the latter receives the majority of their income from this source. On the other hand, a sizeable, through hard to

<sup>25</sup> It is often mentioned that employment in the small business sector in Moscow is more than 50% of total employment. For example, the *Rossiiskii Ekonomicheskii Zhurnal* (1996, no. 3: 52) wrote that it was about 50% at the end of 1995, but the journal probably includes self-employed workers and those working unofficially in small businesses.

quantify, number of workers officially employed by large enterprises work illegally in small businesses because they are on forced vacations or reduced working time, but these are counted among the personnel of large enterprises and others might be registered as part-time, but work full-time or not be registered altogether. The research firm Krona Korsinto (1997: 9-10) estimates that in 1996 25-27% of the population received the majority of their income from working in small businesses (defined as up to 100 employees). Considering also medium businesses (100-500 employees) this percentage would be 60%. These figures are based on the fact that approximately 30-40% of the workers are believed not to be employed regularly. Taking into account that between 1996 and 1998 in St. Petersburg total employment in small businesses had further increased by 20% the percentage of workers employed by firms with up to 100 employees should have been around 30-32.5% in 1998, which is not very far from the levels registered between 1989 and 1991 in countries such as the United States (38.9%) and Canada (40.6%)<sup>26</sup> for firms with up to 100 employees (OECD, 1996a: 21). An even higher figure was provided by the Leontief Center, which estimated that 42.4% of the workforce in St. Petersburg in 1998 was working for small businesses or was self-employed, but it is not clear on which basis this estimation was done (The Socio-Economic ..., 1998, no. 31: 4). The large increase in small business employment is presumably the main reason why unemployment rates in the city are three times lower than in Russia as a whole.

The dynamism of the small business sector is emphasised by the fact that small firms are also investing more than their large and medium counterparts. Thirty-one per cent of all capital investment was made in 1995 by small firms, more than twice as much as their share of the economy (Goskomstat, 1996a: 5), while in Russia as a whole the proportion is the opposite. They accounted for 6.2% of total investment and 12% of the GDP in 1996 (Russian SME ..., 1998: 6/2).

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<sup>26</sup> Other percentages are as follows: Germany 45.6%, France 49.2%, Italy 73.5% Japan 53.8% and the United Kingdom 49.1%.

Another question mark is the share of city output accounted for by small businesses, which is not included among the data published by Goskomstat. A booklet published by the administration gave a figure of 10% for 1996, but according to the Leontief Center it was already 15% in 1994 (Oding, 1995: 13). Hodachek (1998: 13), the deputy director of the Committee for Economy and Industrial Policy, mentioned a share of 32-35% (presumably for 1997), but variations in small business employment do not justify such a difference from 1994 data. However, considering the number of people the small business sector employs, Hodachek's figure seems to be more close to reality. As a comparison, according to Hodachek (1998: 13) the small business share in the Moscow's economy was 54%.

The effects of the changes in 1996 in the criteria utilised to define a small business are also puzzling. These changes have strangely penalised in St. Petersburg a category (trade and public catering) where the limit on the maximum number of employees was increased (yet employment<sup>27</sup> in this category decreased by 21% in that year), while they have affected to a lesser extent two other categories such as industry (-11.3%) and construction (-12.9%) where the limit was reduced by half. This could be due to the fact that the restrictions introduced on the charter capital<sup>28</sup> have excluded a great number of trade and public catering firms, while having much less effect on small enterprises in industry and construction. In 1995 state and municipal firms accounted for 4.9% of small business employment. A further 1.2% was accounted for by social organisations. These kinds of firms (state and municipal firms and social organisations) had a strong presence in science (19.4% of total employment), had a weight close to the average in industry (7.3%) and construction (8.1%), but were very weak in trade and public catering (1%). Also partly state-owned firms accounted for a low share of employment in trade and catering (8% compared with an average of 14%

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<sup>27</sup> From here on in this section when I refer to employment in small businesses I include only full-time employees.

<sup>28</sup> In order to be defined as a small business the share of charter capital belonging to legal entities which are not small businesses, to state, religious, social and charitable organisations and other foundations must be lower than 25%.

for the small business sector in St. Petersburg). Therefore, the exclusion of state and municipal firms, social organisations and partly state-owned firms where the state had more than 25% of the charter capital has had only a minor influence on figures for employment levels in the small business category - trade and public catering. The only explanation is that there was a great number of small trade and public catering firms owned or partially owned by entities which are not considered small by law<sup>29</sup>, but on this matter no information is available. On the contrary, judging from these figures there must be very few small industrial and construction firms where medium and large entities have more than 25% of the charter capital. As many of the newly created industrial firms are believed to be spin-offs from large establishments it would seem that parent enterprises have maintained only a low or no share of the property of these spin-offs. What leaves one perplexed is that in Russia as a whole the change in the criteria has had the opposite effect to St. Petersburg. Small business categories such as industry and construction have been strongly affected, while trade and public catering much less so. This seems to be more logical, because it is more in line with the increases and reductions of the limits in the different sectors.

Since 1998 companies with foreign participation and wholly foreign owned companies have also been included among small businesses. These accounted for 3.0% and 1.1% of total employment respectively (Goskomstat, 1999: 163). Therefore their inclusion does not substantially alter the picture.

The growth of small business has been accompanied by a deep transformation in the composition of this sector. The first wave of small enterprises in St. Petersburg was concentrated in industry, construction and science which together made up 85% of small business employment while trade and public catering had only a marginal role. In the first half of 1992 scientific firms were the biggest sector accounting for 26.9% of the total

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<sup>29</sup> In theory, there could be a great number of small businesses partly owned by social and charitable organisations and other foundations, but given the fact that these entities accounted for a negligible share of total small business employment in 1995, this can be

turnover of all small businesses (Goskomstat, 1992: 2). Many of the firms belonging to these three sectors were presumably spin-offs from larger establishments or privatised units as the average number of employees was much larger than at present and has since progressively decreased. In small industrial, construction and scientific firms it was 21.1, 21.5 and 13.9 respectively in June 1992 compared with 8.8, 8.2 and 4.1 in 1997.

By September 1998 among small businesses the biggest sector was trade and public catering with 269,700 full-time workers, almost twice as many as nine months before. Then in order of importance comes industry with 103,200 workers and construction with 92,300 workers (Goskomstat, 1999: 165). A doubling of employment in just nine months is mind-boggling. Maybe there was a revision of the numbers to take into account non-registered workers, but the other sectors did not register such sharp variations. The share of employment of trade and public catering firms in total small business employment in the city went up from 31.1% to 46.6% in this period. The number of firms in this category has grown faster than in all the other categories and between June 1992 and December 1997 increased by more than fifty times, while employment in this category has risen by twelve and half times in the same period, but taking into consideration the period from 1991 to September 1998 by fifty-five times. As a comparison, in Russia between the end of 1991 and the end of 1997 the total number of small trade and public catering firms increased by about three times, the same ratio as the total number of firms.

Scientific firms are the sector whose importance has declined the most among small businesses. Their share in small business employment decreased from 17.9% of the total in 1991 to 2.9% in September 1998. In contrast they have continued to have a sizeable role in Moscow accounting for 13% of small business employment in 1997. Scientific firms kept increasing up to 1995 (by almost 400%) after which their number has marginally decreased, while the number of full-time employees has

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excluded.

remained stable since 1991 – the only sector not to have posted an increase in employment -, but considering the restrictions introduced in 1996 it is clear that employment would have increased in the second half of the 1990s with unchanged criteria. Yearly employment variations in small scientific firms were strong and sometimes inexplicable. Employment decreased by 26% in 1996 due to the change in the criteria, went up by almost 50% the following year and decreased again by 32% in 1998 (data referring to the period January-September 1998).

Employment in small industrial firms had a strong growth of four and half times between 1991 and 1995. Small businesses accounted for 18% of the industrial production in the city in 1995 employing 21% of the total workforce (Goskomstat, 1996a: 4). Another Goskomstat report indicates the share of small business output in industry to be 24%, including small businesses which are joint-ventures or wholly foreign-owned firms. These numbers compare very favourably with the rest of Russia, as the share of output represented by small industrial firms was 8% in that year (Voprosy Statistiki, 1996, no. 7: 65). After 1995 employment has stabilised, although as with scientific firms the more restricted criteria introduced in 1996 point out that some growth has taken place. The decrease in 1996 equivalent to 11%, counterbalanced by an increase of an approximately equal amount the following year, is clearly the result of the variations in the criteria. If we compare 1996 data with 1995 data referring to private and partly state-owned enterprises the reduction was 4%. As the share of employment of industrial firms with between 100 to 200 employees - which from 1996 onwards are no longer considered small businesses - is likely to be higher than 4% we can affirm that with unchanged criteria a large increase must have taken place. In effect, between 1995 and 1997 the number of small industrial enterprises grew by two-thirds.

The share of budget revenues provided by small business in St. Petersburg is very low, and has even gone down from 17% in 1996 to 12% in 1997 according to data from the Committee of Economics and Finance

(Peterburgskaia Zhizn', 1998: 2), despite the strong increase in small business employment. This is in line with the Russian average which is 10-12%, but is much less than in Moscow – 50% in 1996 - and in other cities where small business had a strong development such as Samara where it accounted for about 30% of the city revenues (Piskotin, 1997: 46). Such a low share is puzzling considering that in Moscow their share of budget revenues broadly corresponds to their share in GDP and in employment. Also at the federal level the contribution of small business (15% of the revenues) is similar to their GDP and employment share. There are no structural differences in the composition of the small business sector to justify such a difference. The share of employment in trade and public catering firms in St. Petersburg was in 1997 not much different from the national share and the same applies to industry and construction. One reason for the low contribution of small business could be that the profitability of small firms is much lower than in Russia in general and plummeted further in 1997. Alternatively revenue collection from small business may be less efficient in St. Petersburg than in other regions. However, St. Petersburg is the region with the second lowest share of loss-making enterprises. Only 6% made a loss in 1996 compared with a Russian average of 20%. Neither does it seem that the unofficial economy is more widespread than in the rest of Russia. According to a study by the Leontief Center (1998: 12), it would account for about 33% of the city's GDP, which is roughly in line with the national figures. The highest coefficient is in retail trade, where it accounts for 69%. The share of revenues provided by the small business sector subsequently increased to 23.4% in the first half of 1999 (Leontief Center, 1999: 2), but this was mainly the result of the introduction of the sales tax, according to Yeliseeva (interview), the person in charge of small business support in the St. Petersburg administration.

### **3.4. CONCLUSION**

Small business statistics have many inconsistencies, such as the sometimes inexplicable variations of figures from one year to another. This creates

doubts over the reliability of these figures. Officially small business in Russia has stagnated after a few years of swift development in the early 1990s, remaining at a level which is well below that in developed market economies and also in the leading transition countries. Small business in Russia has expanded considerably only in a few large cities such as Moscow and St. Petersburg. Even though there are strong question marks over the reliability of these data, and although the limitations of the Russian definition of small business means that data are not fully comparable, there is no doubt that the development has been more restrained in Russia than in the leading transition countries. Data on small business units are considered to be the most reliable indicator. However, data on the total number of enterprises suggest a marked dynamism even in the second half of the nineties. The strong increase of this figure may, however, be due to the fact that many firms which cease activity are not liquidated, but no definite conclusion can be reached on this matter due to the lack of evidence. What is stronger, however, is the evidence provided by employment data of new private businesses which, according to a recent survey, are increasing their share of total employment year after year. Therefore, the official stagnation in small business employment masks a dynamic new private sector. In theory, this might be offset by the shrinking of employment in small privatised firms and by the fact that some new firms might grow so large as to qualify no longer as a small business. The combined effect of these two factors might result in the total number of workers employed by small businesses remaining more or less the same. Unfortunately, due to the lack of evidence we cannot completely discount these explanations, but there is strong ground to believe that official statistics are not capturing the small business sector wholly. A feature of this sector is the high failure rate. As many firms are created out of the desire to exploit the new opportunities unfolding, but without a clear analysis of the market and the economic crisis has lasted much more than expected, they could not survive long.

Small business data in St. Petersburg have several incongruities as in Russia. It may be presumed that data referring to the early 1990s are

underestimates, especially regarding service sector firms while concerning recent data it is unclear why the concentration of small businesses in the total number of firms differ markedly from the rest of Russia (Moscow included). However, employment data leaves no doubt that St. Petersburg has had a large growth in small businesses by Russian standards, even if the level trails substantially behind Moscow. The first wave of entrepreneurs was mainly concentrated in industry, science and construction, while the subsequent growth has been driven in a large part by the creation of service firms. With regard to the level of small business employment St. Petersburg is approaching the levels of some Western countries such as the United States and Canada. Despite the size of the small business sector in St. Petersburg, which is among the biggest in Russia outside Moscow, the share of tax revenues in the city budget generated by this sector are strangely the same as the average in Russia and no reasonable explanation can be found for this except that the data is not correct.

The next chapter provides an economic outlook of St. Petersburg in the nineties and covers the economic policy pursued in this period. It will be shown how the local administration has responded to the changing role which has been thrust upon it following the collapse of the planned system and in particular the kind of approach taken to the industrial sector: has St. Petersburg followed the hands off approach or has intervened heavily.

Economic branches:	RUSSIA: NUMBER OF SMALL FIRMS (in thousands)									
	31/12/91	31/12/92	31/12/93	31/12/94	31/12/95	31/12/96	31/12/97	31/12/98		
Industry	37.5	60	94.7	127.2	128.5	131.9	134.8	136.1		
Agriculture	2.2	6.9	10.9	9.5	9.8	10.9	11.9	13.8		
Transport and communication	7.05	14.1	19.3	17.6	20.5	20.4	21.3	21.8		
Construction	52.1	72.9	92.2	123.5	145.5	138	142.1	137.5		
Trade and catering	125.2	275.5	397.5	419.4	374.6	359.3	372.8	386.1		
Material supplies and sales	5.2	15.2	18.2	15.5	16.2	14.6	14.3	13.2		
Information services	3.6	5.8	8.1	6.2	6.7	6.1	6.4	5.2		
Real estate transactions	0.5	1.1	2.2	1.8	2.2	3.9	4.6	5.9		
General comm. activity to support market functioning	7.1	20.6	63.9	51.9	42.4	35.9	36	35.2		
Other kinds of activity in the sphere of material production	0	13.8	21.4	15.6	16.8	17.4	17.2	18.9		
Housing and public utilities; non-production services rendered to households	4	10.8	17.3	13.5	15.4	13	15.2	14.2		
Health care, physical culture and sport, social security	3.5	9.2	14.4	14.8	16.8	11	15.4	17.2		
Education	2.1	5.8	8.8	6.5	7.8	6.6	7	6.7		
Culture and art	2.3	5.1	7.5	6.7	8.2	6.5	7.9	8.1		
Science and scientific services	10.6	35.9	64.8	51.7	48.8	46.7	43.9	38.8		
Finance, credit, insurance, pension security	2.2	4.3	14.5	10.2	11.6	10.8	7.8	7.5		
Other sectors	1.55	3	9.3	5.3	5.5	8.7	2.5	1.8		
<b>Total</b>	<b>266.7</b>	<b>560.0</b>	<b>865.0</b>	<b>896.9</b>	<b>877.3</b>	<b>841.7</b>	<b>861.1</b>	<b>868.0</b>		

	RUSSIA: SHARE OF EACH BRANCH IN THE TOTAL NUMBER OF SMALL FIRMS									
	31/12/91	31/12/92	31/12/93	31/12/94	31/12/95	31/12/96	31/12/97	31/12/98		
<b>Economic branches:</b>										
Industry	14.1%	10.7%	10.9%	14.2%	14.6%	15.7%	15.7%	15.7%		
Agriculture	0.8%	1.2%	1.3%	1.1%	1.1%	1.3%	1.4%	1.6%		
Transport and communication	2.6%	2.5%	2.2%	2.0%	2.3%	2.4%	2.5%	2.5%		
Construction	19.5%	13.0%	10.7%	13.8%	16.6%	16.4%	16.5%	15.8%		
Trade and catering	46.9%	49.2%	46.0%	46.8%	42.7%	42.7%	43.3%	44.5%		
Material supplies and sales	1.9%	2.7%	2.1%	1.7%	1.8%	1.7%	1.7%	1.5%		
Information services	1.3%	1.0%	0.9%	0.7%	0.8%	0.7%	0.7%	0.6%		
Real estate transactions	0.2%	0.2%	0.3%	0.2%	0.3%	0.5%	0.5%	0.7%		
General comm. activity to support market functioning	2.7%	3.7%	7.4%	5.8%	4.8%	4.3%	4.2%	4.1%		
Other kinds of activity in the sphere of material production	0.0%	2.5%	2.5%	1.7%	1.9%	2.1%	2.0%	2.2%		
Housing and public utilities; non-production services rendered to households	1.5%	1.9%	2.0%	1.5%	1.8%	1.5%	1.8%	1.6%		
Health care, physical culture and sport, social security	1.3%	1.6%	1.7%	1.7%	1.9%	1.3%	1.8%	2.0%		
Education	0.8%	1.0%	1.0%	0.7%	0.9%	0.8%	0.8%	0.8%		
Culture and art	0.9%	0.9%	0.9%	0.7%	0.9%	0.8%	0.9%	0.9%		
Science and scientific services	4.0%	6.4%	7.5%	5.8%	5.6%	5.5%	5.1%	4.5%		
Finance, credit, insurance, pension security	0.8%	0.8%	1.7%	1.1%	1.3%	1.3%	0.9%	0.9%		
Other sectors	0.6%	0.5%	1.1%	0.6%	0.6%	1.0%	0.3%	0.2%		
<b>Total</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>		

	RUSSIA: INCREASE IN THE NUMBER OF SMALL FIRMS OVER THE PREVIOUS YEAR									
	30/06/92	31/12/92	31/12/93	31/12/94	31/12/95	31/12/96	31/12/97	31/12/98	98/91	
<b>Economic branches:</b>										
Industry		60.0%	57.8%	34.3%	1.0%	2.6%	2.2%	1.0%	262.9%	
Agriculture		213.6%	58.0%	-12.8%	3.2%	11.2%	9.2%	16.0%	527.3%	
Transport and communication		100.0%	36.9%	-8.8%	16.5%	-0.5%	4.4%	2.3%	209.2%	
Construction		39.9%	26.5%	33.9%	17.8%	-5.2%	3.0%	-3.2%	163.9%	
Trade and catering		120.0%	44.3%	5.5%	-10.7%	-4.1%	3.8%	3.6%	208.4%	
Material supplies and sales		192.3%	19.7%	-14.8%	4.5%	-9.9%	-2.1%	-7.7%	153.8%	
Information services		61.1%	39.7%	-23.5%	8.1%	-9.0%	4.9%	-18.8%	44.4%	
Real estate transactions		120.0%	100.0%	-18.2%	22.2%	77.3%	17.9%	28.3%	1080.0%	
General comm. activity to support market functioning		190.1%	210.2%	-18.8%	-18.3%	-15.3%	0.3%	-2.2%	395.8%	
Other kinds of activity in the sphere of material production			55.1%	-27.1%	7.7%	3.6%	-1.1%	9.9%		
Housing and public utilities, non-production services rendered to households		170.0%	60.2%	-22.0%	14.1%	-15.6%	16.9%	-6.6%	255.0%	
Health care, physical culture and sport, social security		162.9%	56.5%	2.8%	13.5%	-34.5%	40.0%	11.7%	391.4%	
Education		176.2%	51.7%	-26.1%	20.0%	-15.4%	6.1%	-4.3%	219.0%	
Culture and art		121.7%	47.1%	-10.7%	22.4%	-20.7%	21.5%	2.5%	252.2%	
Science and scientific services		238.7%	80.5%	-20.2%	-5.6%	-4.3%	-6.0%	-11.6%	266.0%	
Finance, credit, insurance, pension security		95.5%	237.2%	-29.7%	13.7%	-6.9%	-27.8%	-3.8%	240.9%	
Other sectors		93.5%	210.0%	-43.0%	3.8%	58.2%	-71.3%	-28.0%	16.1%	
<b>Total</b>		<b>110.0%</b>	<b>54.5%</b>	<b>3.7%</b>	<b>-2.2%</b>	<b>-4.1%</b>	<b>2.3%</b>	<b>0.8%</b>	<b>225.5%</b>	

	RUSSIA: NUMBER OF SMALL BUSINESS WORKERS (in thousands)									
	31/12/91	31/12/92	31/12/93	31/12/94	31/12/95	31/12/96	31/12/97	31/12/98		
<b>Economic branches:</b>										
Industry	.	.	.	2,575.4	2,589.7	1,399.7	1,427.0	1,357.6		
Agriculture	.	.	.	93.5	93.5	120.7	121.4	138.7		
Transport and communication	.	.	.	157.3	167.5	181.7	207.0	203.4		
Construction	.	.	.	2,605.5	2,624.4	1,604.3	1,612.8	1,344.9		
Trade and catering	.	.	.	2,145.8	2,196.4	1,866.5	1,901.4	2,202.9		
Material supplies and sales	.	.	.	123.9	123.7	96.5	96.5	90.6		
Information services	.	.	.	33.9	33.8	26.8	26.8	23.0		
Real estate transactions	.	.	.	0.0	0.0	0.0	0.0	27.5		
General comm. activity to support market functioning	.	.	.	351.0	320.8	203.0	208.9	193.6		
Other kinds of activity in the sphere of material production	.	.	.	0.0	0.0	0.0	0.0	165.1		
Housing and public utilities; non-production services rendered to households	.	.	.	100.0	106.8	82.4	105.6	92.3		
Health care, physical culture and sport, social security	.	.	.	80.5	88.4	61.2	61.2	100.6		
Education	.	.	.	92.4	93.8	72.2	72.2	42.6		
Culture and art	.	.	.	0.0	0.0	0.0	0.0	34.5		
Science and scientific services	.	.	.	231.9	231.9	161.7	166.3	146.3		
Finance, credit, insurance, pension security	.	.	.	0.0	0.0	0.0	0.0	34.5		
Other sectors	.	.	.	269.4	274.1	290.8	290.8	9.7		
<b>Total</b>	<b>5,440</b>	<b>7,680</b>	<b>8,630</b>	<b>8,860.5</b>	<b>8,944.8</b>	<b>6,167.5</b>	<b>6,297.9</b>	<b>6,207.8</b>		

These figures refer to full-time workers

	RUSSIA: SHARE OF SMALL BUSINESS WORKERS IN EACH BRANCH									
	31/12/91	31/12/92	31/12/93	31/12/94	31/12/95	31/12/96	31/12/97	31/12/98		
<b>Economic branches:</b>										
Industry	.	.	.	29.1%	29.0%	22.7%	22.7%	21.9%		
Agriculture	.	.	.	1.1%	1.0%	2.0%	1.9%	2.2%		
Transport and communication	.	.	.	1.8%	1.9%	2.9%	3.3%	3.3%		
Construction	.	.	.	29.4%	29.3%	26.0%	25.6%	21.7%		
Trade and catering	.	.	.	24.2%	24.6%	30.3%	30.2%	35.5%		
Material supplies and sales	.	.	.	1.4%	1.4%	1.6%	1.5%	1.5%		
Information services	.	.	.	0.4%	0.4%	0.4%	0.4%	0.4%		
Real estate transactions	.	.	.	0.0%	0.0%	0.0%	0.0%	0.4%		
General comm. activity to support market functioning	.	.	.	4.0%	3.6%	3.3%	3.3%	3.1%		
Other kinds of activity in the sphere of material production	.	.	.	0.0%	0.0%	0.0%	0.0%	2.7%		
Housing and public utilities; non-production services rendered to households	.	.	.	1.1%	1.2%	1.3%	1.7%	1.5%		
Health care, physical culture and sport, social security	.	.	.	0.9%	1.0%	1.0%	1.0%	1.6%		
Education	.	.	.	1.0%	1.0%	1.2%	1.1%	0.7%		
Culture and art	.	.	.	0.0%	0.0%	0.0%	0.0%	0.6%		
Science and scientific services	.	.	.	2.6%	2.6%	2.6%	2.6%	2.4%		
Finance, credit, insurance, pension security	.	.	.	0.0%	0.0%	0.0%	0.0%	0.6%		
Other sectors	.	.	.	3.0%	3.1%	4.7%	4.6%	0.2%		
Total	.	.	.	100.0%	100.0%	100.0%	100.0%	100.0%		

RUSSIA: INCREASE IN THE NUMBER OF SMALL BUSINESS WORKERS OVER THE PREVIOUS YEAR											
Economic branches:	31/12/91	31/12/92	31/12/93	31/12/94	31/12/95	31/12/96	31/12/97	31/12/98	31/12/99	31/12/00	31/12/01
Industry	.	.	.	.	1%	-46%	2%	-5%	-47.3%		
Agriculture	.	.	.	.	0%	29%	1%	14%	48.3%		
Transport and communication	.	.	.	.	6%	8%	14%	-2%	29.3%		
Construction	.	.	.	.	1%	-39%	1%	-17%	-48.4%		
Trade and catering	.	.	.	.	2%	-15%	2%	16%	2.7%		
Material supplies and sales	.	.	.	.	0%	-22%	0%	-6%	-26.9%		
Information services	.	.	.	.	0%	-21%	0%	-14%	-32.2%		
Real estate transactions	.	.	.	.							
General comm. activity to support market functioning	.	.	.	.	-9%	-37%	3%	-7%	-44.8%		
Other kinds of activity in the sphere of material production	.	.	.	.							
Housing and public utilities; non-production services rendered to households	.	.	.	.	7%	-23%	28%	-13%	-7.7%		
Health care, physical culture and sport, social security	.	.	.	.	10%	-31%	0%	64%	25.0%		
Education	.	.	.	.	2%	-23%	0%	-41%	-53.9%		
Culture and art	.	.	.	.							
Science and scientific services	.	.	.	.	0%	-30%	3%	-12%	-36.9%		
Finance, credit, insurance, pension security	.	.	.	.							
Other sectors	.	.	.	.	2%	6%	0%	-97%	-96.4%		
<b>Total</b>					1%	-31%	2%	-1%	-29.9%		

These figures refer to full-time workers  
The gaps are due to the fact that these data could not be found.

	ST. PETERSBURG: NUMBER OF SMALL FIRMS										
	30/06/92	31/12/92	31/12/93	31/12/94	31/12/95	31/12/96	31/12/97	31/12/98	31/12/99	31/12/00	31/12/01
<b>Economic branches:</b>											
Industry	1,407	1,933	5,384	11,736	10,068	14,218	16,757	19,453			
Agriculture	11	16	53	46	65	281	366	0			
Transport and communication	110	139	523	1,606	1,801	2,128	2,571	3,689			
Construction	1,190	1,655	4,662	10,601	9,695	13,384	14,160	17,441			
Trade and catering	846	1,827	5,436	18,176	28,558	36,745	44,775	52,546			
Material supplies and sale..	32	0	0	967	924	806	936	0			
Information services	15	119	283	190	254	402	532	447			
Real estate transactions	0	0	0	99	256	659	854	0			
General comm. activity to support market functioning	324	0	682	2,027	3,016	3,011	3,651	3,130			
Other kinds of activity in the sphere of material production	0	411	208	521	590	724	2,929	0			
Housing and public utilities; non-production services rendered to households	237	0	0	0	585	220	0	1,789			
Health care, physical culture and sport, social security	197	307	581	1,778	2,162	1,450	2,937	2,795			
Education	82	144	274	751	880	802	1,104	671			
Culture and art	84	125	256	768	1,004	1,068	1,416	1,230			
Science and scientific services	1,257	1,803	3,248	5,810	6,879	6,631	6,513	3,242			
Finance, credit, insurance, pension security	0	0	0	0	805	1,250	0	0			
Other sectors	305	1,218	1,105	1,996	837	4,459	1,954	5,366			
<b>Total</b>	<b>6,097</b>	<b>9,697</b>	<b>22,695</b>	<b>57,072</b>	<b>68,379</b>	<b>88,238</b>	<b>101,455</b>	<b>111,800</b>			

TABLE 3.11. ST. PETERSBURG: SHARE OF EACH BRANCH IN THE TOTAL NUMBER OF SMALL FIRMS										
Economic branches:	30/06/92	31/12/92	31/12/93	31/12/94	31/12/95	31/12/96	31/12/97	31/12/98		
Industry	23.1%	19.9%	23.7%	20.6%	14.7%	16.1%	16.5%	17.4%		
Agriculture	0.2%	0.2%	0.2%	0.1%	0.1%	0.3%	0.4%	0.0%		
Transport and communication	1.8%	1.4%	2.3%	2.8%	2.6%	2.4%	2.5%	3.3%		
Construction	19.5%	17.1%	20.5%	18.6%	14.2%	15.2%	14.0%	15.6%		
Trade and catering	13.9%	18.8%	24.0%	31.8%	41.8%	41.6%	44.1%	47.0%		
Material supplies and sale:	0.5%	0.0%	0.0%	1.7%	1.4%	0.9%	0.9%	0.0%		
Information services	0.2%	1.2%	1.2%	0.3%	0.4%	0.5%	0.5%	0.4%		
Real estate transactions	0.0%	0.0%	0.0%	0.2%	0.4%	0.7%	0.8%	0.0%		
General comm. activity to support market functioning	5.3%	0.0%	3.0%	3.6%	4.4%	3.4%	3.6%	2.8%		
Other kinds of activity in the sphere of material production	0.0%	4.2%	0.9%	0.9%	0.9%	0.8%	2.9%	0.0%		
Housing and public utilities; non-production services rendered to households	3.9%	0.0%	0.0%	0.0%	0.9%	0.2%	0.0%	1.6%		
Health care, physical culture and sport, social security	3.2%	3.2%	2.6%	3.1%	3.2%	1.6%	2.9%	2.5%		
Education	1.3%	1.5%	1.2%	1.3%	1.3%	0.9%	1.1%	0.6%		
Culture and art	1.4%	1.3%	1.1%	1.3%	1.5%	1.2%	1.4%	1.1%		
Science and scientific services	20.6%	18.6%	14.3%	10.2%	10.1%	7.5%	6.4%	2.9%		
Finance, credit, insurance, pension security	0.0%	0.0%	0.0%	0.0%	1.2%	1.4%	0.0%	0.0%		
Other sectors	5.0%	12.6%	4.9%	3.5%	1.2%	5.1%	1.9%	4.8%		
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%		

TABLE 3.12. ST. PETERSBURG: INCREASE IN THE NUMBER OF SMALL FIRMS OVER THE PREVIOUS YEAR										
Economic branches:	30/06/92	31/12/92	31/12/93	31/12/94	31/12/95	31/12/96	31/12/97	31/12/98	98/92	
Industry		37%	179%	118%	-14%	41%	18%	16%		1283%
Agriculture		45%	231%	-13%	41%	332%	30%	-100%		
Transport and communication		26%	276%	207%	12%	18%	21%	44%		3254%
Construction		39%	182%	127%	-9%	38%	6%	23%		1366%
Trade and catering		116%	198%	234%	57%	29%	22%	17%		6111%
Material supplies and sales		-100%			-4%	-13%	16%	-100%		
Information services		693%	138%	-33%	34%	58%	32%	-16%		2881%
Real estate transactions					159%	157%	30%	-100%		
General comm. activity to support market functioning		-100%		197%	49%	0%	21%	-14%		866%
Other kinds of activity in the sphere of material production			-49%	150%	13%	23%	305%	-100%		
Housing and public utilities; non-production services rendered to households		-100%				-62%	-100%			655%
Health care, physical culture and sport, social security		56%	89%	206%	22%	-33%	103%	-5%		1319%
Education		76%	90%	174%	17%	-9%	38%	-39%		718%
Culture and art		49%	105%	200%	31%	6%	33%	-13%		1364%
Science and scientific services		43%	80%	79%	18%	-4%	-2%	-50%		158%
Finance, credit, insurance, pension security						55%	-100%			
Other sectors		299%	-9%	81%	-58%	433%	-56%	175%		1659%
<b>Total</b>		<b>59%</b>	<b>134%</b>	<b>151%</b>	<b>20%</b>	<b>29%</b>	<b>15%</b>	<b>10%</b>		<b>1734%</b>

Economic branches:	31/12/91	30/06/92	31/12/93	31/12/94	31/12/95	31/12/96	31/12/97	30/09/98
Industry	22.2	29.7	.	.	109	96.7	113.4	103.2
Agriculture	0	0.1	.	.	0.3	0.6	0.0	1.1
Transport and communication	0.7	2.2	.	.	15.3	16.7	22.8	19.9
Construction	20.2	25.6	.	.	137.8	120	116.5	92.3
Trade and catering	4.9	12.8	.	.	146.4	115.9	161.0	269.7
Material supplies and sale; <sup>3</sup>	0.1	0.6	.	.	4.8	3.4	0.0	4.7
Information services	0.1	0.1	.	.	1.3	1.5	27.4	2.4
Real estate transactions	0	0	.	.	1.5	5.4	0.0	4.1
General comm. activity to support market functioning	0.7	2.8	.	.	14.9	12.9	11.4	16.3
Other kinds of activity in the sphere of material production	0	0	.	.	0	4.6	0.0	7
Housing and public utilities; non-production services rendered to households	2.3	4.3	.	.	4	0.9	10.4	2.6
Health care, physical culture and sport, social security	1.5	2.5	.	.	9.5	7	12.4	13.1
Education	0.4	0.6	.	.	4.1	1.9	3.6	3
Culture and art	0.7	0.9	.	.	4.2	1.8	7.8	6.3
Science and scientific services	17.9	17.5	.	.	22.7	16.8	26.4	16.6
Finance, credit, insurance, pension security	0	0	.	.	3.8	3.2	4.7	3.6
Other sectors	1.2	2.8	.	.	10.9	25.1	0.0	12.7
<b>Total</b>	<b>72.9</b>	<b>102.5</b>	<b>187.4</b>	<b>336.9</b>	<b>490.5</b>	<b>434.4</b>	<b>517.6</b>	<b>578.6</b>

These figures refer to full-time workers

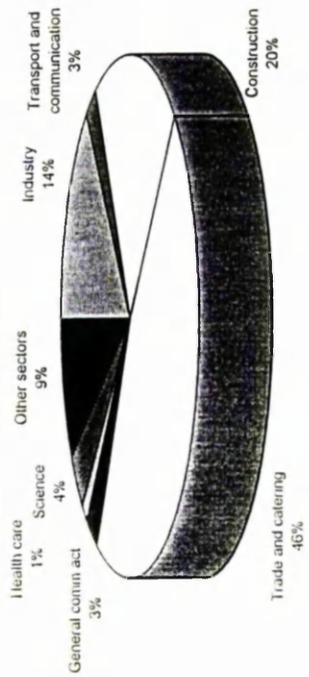
	ST. PETERSBURG: SHARE OF SMALL BUSINESS WORKERS IN EACH BRANCH									
	31/12/91	30/06/92	31/12/93	31/12/94	31/12/95	31/12/96	31/12/97	30/09/98		
Economic branches:										
Industry	30.5%	29.0%	.	.	22.2%	22.3%	21.9%	17.8%		
Agriculture	0.0%	0.1%	.	.	0.1%	0.1%	0.0%	0.2%		
Transport and communication	1.0%	2.1%	.	.	3.1%	3.8%	4.4%	3.4%		
Construction	27.7%	25.0%	.	.	28.1%	27.6%	22.5%	16.0%		
Trade and catering	6.7%	12.5%	.	.	29.8%	26.7%	31.1%	46.6%		
Material supplies and sale	0.1%	0.6%	.	.	1.0%	0.8%	0.0%	0.8%		
Information services	0.1%	0.1%	.	.	0.3%	0.3%	5.3%	0.4%		
Real estate transactions	0.0%	0.0%	.	.	0.3%	1.2%	0.0%	0.7%		
General comm. activity to support market functioning	1.0%	2.7%	.	.	3.0%	3.0%	2.2%	2.8%		
Other kinds of activity in the sphere of material production	0.0%	0.0%	.	.	0.0%	1.1%	0.0%	1.2%		
Housing and public utilities; non-production services rendered to households	3.2%	4.2%	.	.	0.8%	0.2%	2.0%	0.4%		
Health care, physical culture and sport, social security	2.1%	2.4%	.	.	1.9%	1.6%	2.4%	2.3%		
Education	0.5%	0.6%	.	.	0.8%	0.4%	0.7%	0.5%		
Culture and art	1.0%	0.9%	.	.	0.9%	0.4%	1.5%	1.1%		
Science and scientific services	24.6%	17.1%	.	.	4.6%	3.9%	5.1%	2.9%		
Finance, credit, insurance, pension security	0.0%	0.0%	.	.	0.8%	0.7%	0.9%	0.6%		
Other sectors	1.6%	2.7%	.	.	2.2%	5.8%	0.0%	2.2%		
Total	100.0%	100.0%	.	.	100.0%	100.0%	100.0%	100.0%		

These figures refer to full-time workers

TABLE 3.15. ST. PETERSBURG: INCREASE IN THE NUMBER OF SMALL BUSINESS WORKERS OVER THE PREVIOUS YEAR									
Economic branches:	31/12/91	30/06/92	31/12/93	31/12/94	31/12/95	31/12/96	31/12/97	30/09/98	98/92
Industry	.	34%	.	.	.	-11%	17%	-9%	365%
Agriculture	.	.	.	.	.	100%	-100%	.	.
Transport and communication	.	214%	.	.	.	9%	36%	-13%	2743%
Construction	.	27%	.	.	.	-13%	-3%	-21%	357%
Trade and catering	.	161%	.	.	.	-21%	39%	68%	5404%
Material supplies and sales	.	500%	.	.	.	-29%	-100%	.	4600%
Information services	.	0%	.	.	.	15%	1729%	-91%	2300%
Real estate transactions	.	.	.	.	.	260%	-100%	.	.
General comm. activity to support market functioning	.	300%	.	.	.	-13%	-12%	43%	2229%
Other kinds of activity in the sphere of material production	.	.	.	.	.	.	-100%	.	.
Housing and public utilities; non-production services rendered to households	.	87%	.	.	.	-78%	1050%	-75%	13%
Health care, physical culture and sport, social security	.	67%	.	.	.	-26%	77%	5%	773%
Education	.	50%	.	.	.	-54%	91%	-17%	650%
Culture and art	.	29%	.	.	.	-57%	331%	-19%	800%
Science and scientific services	.	-2%	.	.	.	-26%	57%	-37%	-7%
Finance, credit, insurance, pension security	.	.	.	.	.	-16%	46%	-23%	.
Other sectors	.	133%	.	.	.	130%	-100%	.	958%
<b>Total</b>	.	<b>41%</b>	<b>83%</b>	<b>80%</b>	<b>46%</b>	<b>-11%</b>	<b>19%</b>	<b>12%</b>	<b>694%</b>

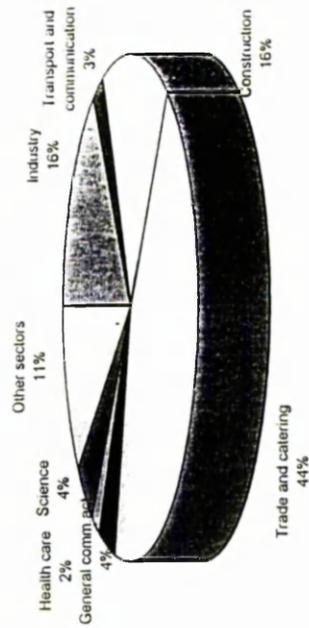
**GRAPH 3.2.**

**Russia: share of each sector in the total number of small businesses at 31/12/91**



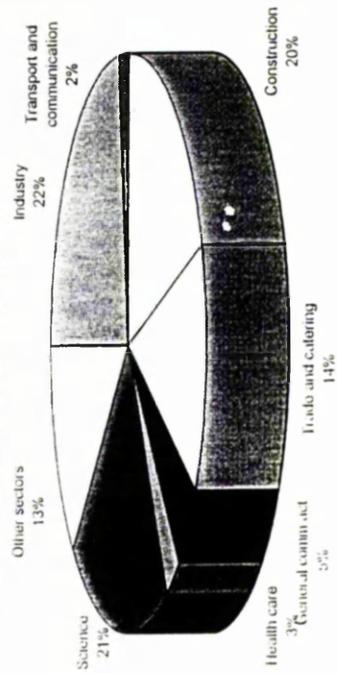
**GRAPH 3.3.**

**Russia: share of each sector in the total number of small businesses at 31/12/98**



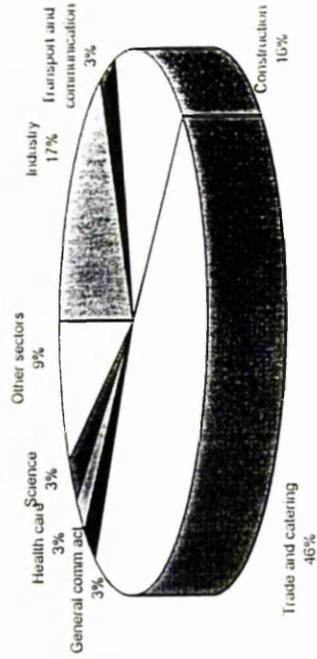
**GRAPH 3.4.**

**St. Petersburg: share of each sector in the total number of small businesses at 30/06/92**

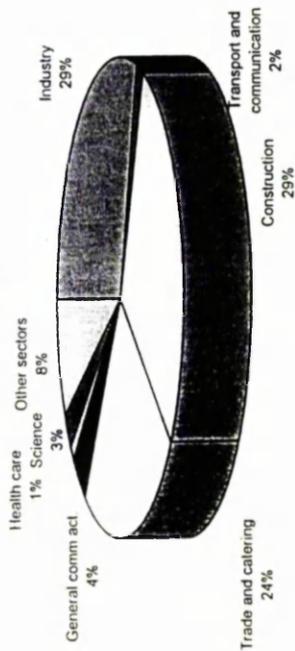


**GRAPH 3.5.**

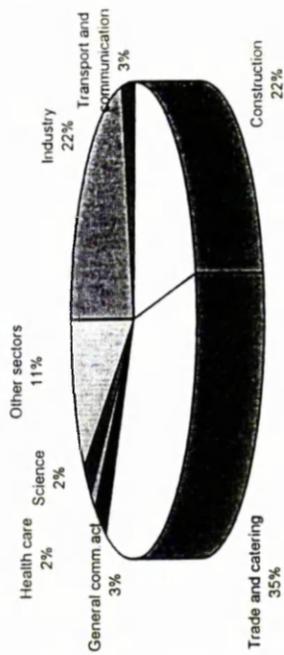
**St. Petersburg: share of each sector in the total number of small businesses at 31/12/98**



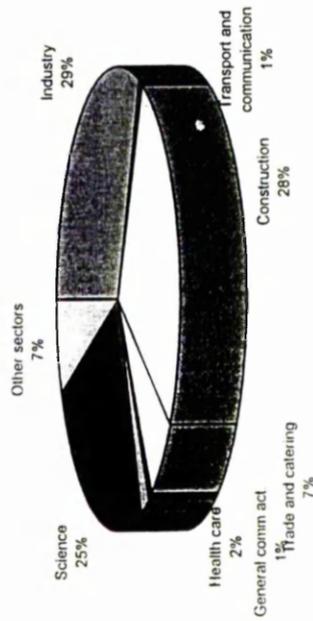
**GRAPH 3.6.**  
Russia: employment in small businesses divided by sector at 31/12/94



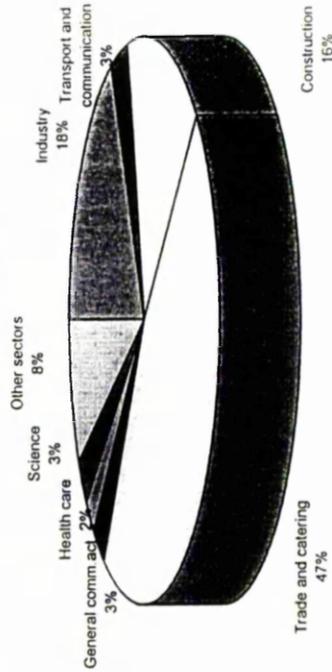
**GRAPH 3.7.**  
Russia: employment in small businesses divided by sector at 31/12/98



**GRAPH 3.8.**  
St. Petersburg: employment in small businesses divided by sector at 31/12/91



**GRAPH 3.9.**  
St. Petersburg: employment in small businesses divided by sector at 30/09/98



These graphs refer to the number of full-time small business workers

## **4. ST. PETERSBURG**

### **INTRODUCTION**

The chapter will start with a brief review of the economic structure in Leningrad to explain the inheritance left by communist rule. I then analyse how St. Petersburg has fared in the post-Soviet period since it lost its role as one of the major defence centres in the Soviet Union. In the communist period, industry and scientific research, the main pillars of the local economy, were geared to military needs. Next I examine political and fiscal reforms. I will show how the role of the local government in the city has changed and how the government responded to the changes which thrust upon it a set of new responsibilities it had never previously faced. Government policy in relation to industry is subsequently discussed. Has it maintained a low profile in accordance with the shock therapy adopted in Russia or it has intervened strongly in the local economy? Did it try to create a favourable environment for local businesses? Have the old state enterprises maintained a strong leverage over the local government? Big enterprises have a vital role in spawning small firms. Therefore, the growth of small businesses will be greatly related to the well-being of the large establishments which dominated the industrial structures of the former communist countries. As many services and non-core production processes were internalised in these establishments, there is great potential for the creation of small businesses from large firms.

#### **4.1. BRIEF ECONOMIC HISTORY OF LENINGRAD**

St. Petersburg was founded as a capital and strategic city, but its favourable position and the developed transportation system represented by a network of canals connecting the city with the central and northern part of Russia, acted as a catalyst for industry in the nineteenth century. Under Tsarist rule the city also became an important educational centre, with the foundation of

the Russian Academy of Sciences and several universities, and a leading financial centre hosting several foreign banks.

The advent of communism meant that the principles on which the city based its development - Russian window to the west and Russian financial centre - lost their importance. In addition, it lost its status of capital to Moscow and subsequently the status of the main scientific centre in Russia, as the transfer of the capital to Moscow was followed by the transfer of the headquarters of the Academy of Sciences. The emphasis of Soviet rule was to make St. Petersburg a major centre for the very industries which dominated the Soviet economy (machine construction, shipbuilding and other heavy industries) (Ruble, 1990: 15). From the 1950s onwards investment, employment and training were concentrated in high-technology engineering industry, as planners had assigned to Leningrad the role of a major centre for technological innovation. For this reason Leningrad-based research evolved towards applied research which could be more easily exploited by industry. The labour force employed in the science sector underwent a strong increase, especially between 1965 and 1975 when it almost doubled (Ruble, 1990: 124).

Ever since the fifth five-year plan (1951-1955) there has been an attempt by the Leningrad authorities to encourage innovation through the institutional integration of R&D and production cycles (Ruble, 1990: 18). To foster the adoption of innovation, industries were amalgamated in industrial production associations, which under a single managerial unit combined factories, research centres and scientific facilities engaged in related activities. By 1978 these accounted for between 80% and 90% of the total output, whereas in the Soviet Union as a whole the share of these production associations was equivalent to half of the industrial output (Ruble, 1990: 121). A stricter control of decision making was deemed necessary in order to overcome managerial resistance to innovation.

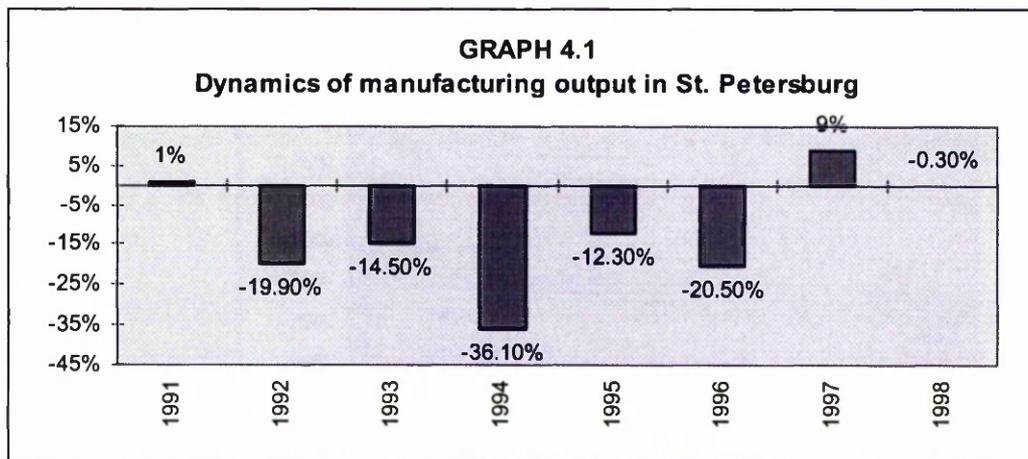
The industrial production associations, which resulted in an even greater centralisation of industry, represented the opposite of Gorbachev's reforms for a higher decentralisation and were, therefore, progressively disbanded in the 1980s. A new campaign "Intensification 90" was launched in 1984, - almost a prelude to Gorbachev's campaign aimed at bringing Soviet industry onto a par with world standards. Unlike the earlier policy to promote the development of new technologies, the aim of this campaign was to oblige industry to absorb technology that already existed by breaking managers' resistance to innovation. A vast programme of automatisisation and computerisation was envisaged to improve productivity. This programme, however, as well as the previous programmes failed to bring about the expected results. As acknowledged by the first secretary of the St. Petersburg communist party, Gerasimov, the introduction of technological innovation in the workplace turned out to be more difficult to attain than previously recognised by the architects of "Intensification-90". A new paradigm, the concept of conversion, emerged in the mid-80's, but it was unheeded until later in the decade, when military orders began to fall away. Conversion objectives were assigned, but the state provided negligible, if any, financing to restructure, leaving to each factory the burden of making the conversion from military to civilian output. For a city where defence enterprises had a major role it meant finding new models of development.

#### **4.2. OVERVIEW OF THE INDUSTRIAL SECTOR IN ST. PETERSBURG**

Leningrad was not greatly industrialised by Soviet standards. Among the Russian cities with more than one million inhabitants only Rostov on Don and Moscow had a lower share of employment in industry than St. Petersburg in 1990. The share of employment in industry accounted for 33.1% of the total in 1990, while most Soviet cities had a share of between 36% and 47%. The city accounted for 2.9% of industrial production in Russia in 1991, though it had 3.4% of the population (Sankt-Peterburgski Universitet Ekonomiki i Finansov, 1993: 60-66). St. Petersburg's industry

was dominated by the sectors which have been hit hardest by the crisis. It was largely defence-related, with a substantial presence of light industry. All major industries in St. Petersburg were linked to the military complex, but, as everywhere in the former Soviet Union, were also responsible for producing a substantial share of civilian goods.

Because of this the fall in industrial production was steeper than in Russia in general until 1996, which itself was characterised by a very steep fall. Industrial production decreased by 20.5% and investment by 16.2% in 1996, while local GDP dropped by 8.7% (Goskomstat, 1998b: 3), but the following year a substantial recovery began, while in Russia as a whole industrial recovery has been weak.



A common feature of the years 1992-1996 is that regions producing more sophisticated outputs were in a more vulnerable position. The highest rates of decline were recorded in the central (including Moscow) and north-west regions (including St. Petersburg), which are the most developed parts of Russia, while West and East Siberia, regions abundant in natural resources, have suffered much less from de-industrialisation. Regions specialising in the extraction and processing of raw materials have few difficulties selling their produce, while the central and the north-west regions' industries are not competitive in the world market. Industrial output in St. Petersburg

amounted in 1996 to 30.8%<sup>1</sup> of its 1990 level, while in Russia as a whole the corresponding percentage was 44%. The decrease was accompanied by deep structural changes. The share of military production in the city's industrial output was down to 10% at the beginning of 1997 (Zhilinskaia, 1997: 15). Light industry was almost extinguished by 1995, with a share of the local market of only about 10% (The Socio-Economic Situation in St. Petersburg. A General Overview, 1996, no. 23: 17). Output in 1996 was a mere 7.5% of its 1990 levels in this sector (The Socio-Economic ..., 1997, no. 25: 16), while in Russia as a whole the relative percentage was 13%. In St. Petersburg production of articles such as television sets, tape recorders and other radio engineering articles was decimated by foreign competition, falling in 1996 to between 2% and 9% of the 1990 levels (Bagrov, 1997: 10). In the other economic sectors production levels in 1996<sup>2</sup> stood at the following percentages of their 1990 levels (The Socio-Economic ..., 1997, no. 25: 16):

- food industry 61.1%
- electric power industry 58.6%
- construction materials industry 34.5%
- chemical and oil industry 34.3%
- machine-building and metal working 32.9%
- metallurgy 30.9%
- fuel industry 23.2%
- wood-processing and wood and pulp industry 14.6%

Due to the distortions in price levels in the old system, changes in the contribution of each sector to the total industrial output of the city do not necessarily reflect the differences between the output changes, but are

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<sup>1</sup> Unless otherwise stated figures on industrial production refer only to large and medium enterprises, as Goskomstat statistics are based on these categories of enterprise. There is a disparity because not all the data are concurrent. Statistics for some topics are published in "one off" publications of research centres and the city administration and are not included in official statistics.

<sup>2</sup> Data for 1997 and 1998 are reported by Goskomstat (1998b: 11 and 1999: 10), but there are some inconsistencies with the data reported in the magazine "The Socio-Economic Situation in St. Petersburg. A General Overview" (see table 4.1 on page 155). For this reason the comparison covers the period only up to 1996.

strongly influenced by the variations in relative prices. Between 1991 and 1996, electric power increased its share of the city's industrial output from 4.8% to 22.2%, while the fact that its output fall was slightly less than half the average output fall in the city would have justified only a doubling of its share. This is the result of the fact that energy prices were very low in the Soviet period. For the opposite reason the contribution of light industry to the total industrial production of the city fell by more than the reduction in its production level should have justified. It fell from 17.3% in 1991 to 2.8% in 1996. The change in the contribution of the food industry, whose share grew from 11.8% to 18% in the same period, and of the main industrial sector in St. Petersburg - machine-building and metal works - are, instead, in line with their output variations.

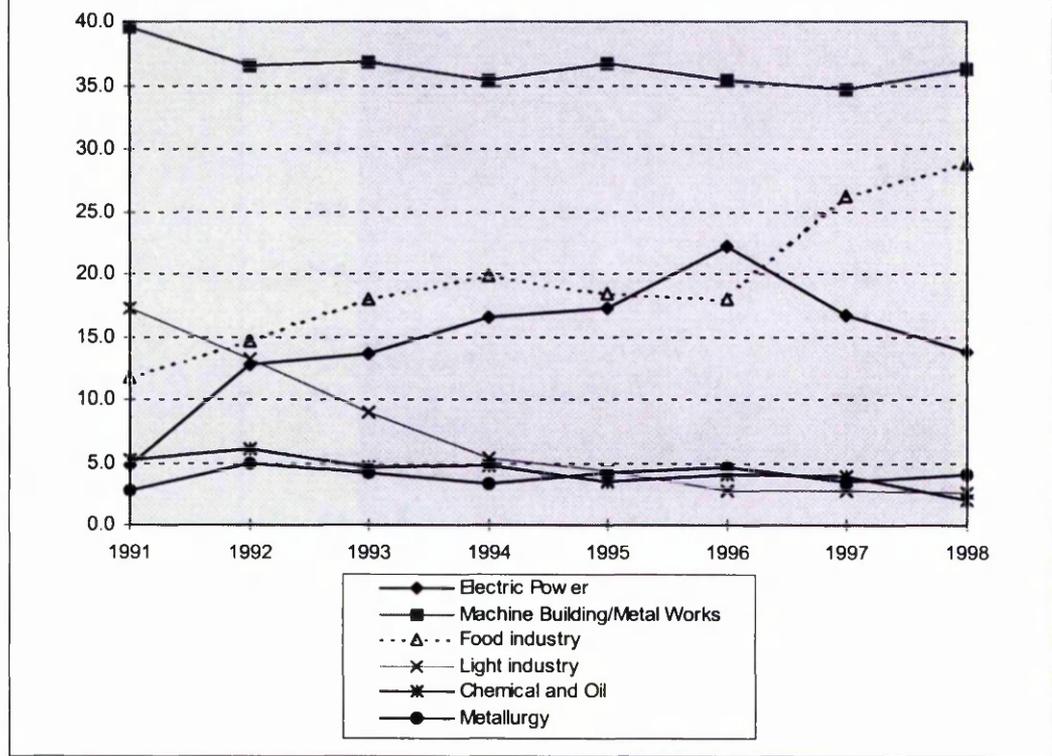
TABLE 4.1  
Industrial structure in St. Petersburg

	Share of industrial output (in current prices)								Share of employ- ment	
	1991	1992	1993	1994	1995	1996	1997	1998	1991	1996
Electric Power	4.8	12.7	13.6	16.5	17.2	22.2	16.6	13.7	1.3	3.2
Machine Building/Metal Works	39.6	36.5	36.8	35.4	36.6	35.4	34.6	36.3	70.5	61.9
Food	11.8	14.7	17.9	19.8	18.4	18.0	26.3	28.8	5.2	7.8
Light Industry	17.3	13.2	9.0	5.4	4.4	2.8	2.7	2.6	9.1	8.0
Chemical and Oil Industry	5.2	6.1	4.6	4.8	3.5	4.1	3.9	2.0	4.0	4.1
Metallurgy	2.7	4.9	4.2	3.4	4.2	4.6	3.5	4.0	1.0	2.8
Wood-Processing and Wood and Pulp Industry	3.6	3.1	3.4	3.5	3.5	2.9	2.9	2.3	2.9	3.9
Construction Materials	1.8	2.4	3.3	4.0	3.0	2.7	3.5	3.3	1.9	2.0
Others	13.2	6.4	7.2	7.2	7.2	7.3	6.0	7.5	4.1	6.3
Total	100.0	100.0	100.0	100.0	98.0	100.0	100.0	100.5	100.0	100.0

Source: Days of Economics of St. Petersburg page 3 and Goskomstat..., 1997b: 42

There is a mistake in the years 1995 and 1998, as the total is not 100

**GRAPH 4.2.**  
**Share of the main sectors in total industrial production in St. Petersburg**



The share of industry in the total amount of investments fell from 34.3% in 1991 to 20.9% in 1994 and increased slightly to 24.9% in 1996, while the share of transport has gone up from 16.9% in 1991 to 24.9% in 1996 (Strategicheskii Plan Sankt-Peterburga, 1998: 28) in line with the policies pursued by the Sobchack administration (1991-1996), which will be discussed in section 4.5. One positive sign is that exports increased from 3.5% to 5.6% of total industrial output between 1994 and 1996. More than half of these exports are represented by machinery and equipment (Goskomstat, 1997b: 66).

In spite of the crisis it has experienced, local industry still provided 57% of the tax revenues of St. Petersburg in 1996 (City of Saint Petersburg 1996, 1997: 17), employed 24.4% of its working population compared with

33.1% in 1990 and accounted for 30.4%<sup>3</sup> of the GDP (Strateghiceskii Plan Sankt-Peterburga, 1998: 27). The number of employees in manufacturing decreased from 458,300 in 1994 to 378,100 in 1996 (Goskomstat, 1997b: 34-5; The Socio-Economic ..., 1998, no. 31: 24), a reduction of 18%, while in these two years output reduction has amounted to 30%. However, the number of industrial workers continued to decrease in 1997, amounting at the end of the year to 333,000, a drop of 11.9%, in contrast to the output trend (The Socio-Economic ..., 1998, no. 31: 4). Local factories, despite the crisis, have been slow to reduce excess personnel. The share of city employment represented by light industry only decreased from 9.1% to 8.0% from 1991 to 1996, notwithstanding the huge output fall (Strateghiceskii Plan Sankt-Peterburga, 1998: 28).

As can be expected, mixed and private companies had the highest productivity in 1996<sup>4</sup> accounting for 58.7% and 29.7% of the city's industrial output, while employing 50.8% and 25.6% of the total workforce respectively. Instead, state enterprises (in large part defence companies) are grossly overmanned since they turn out only 11.6% of the local industrial production, but employ 23.6% of industrial workers. Statistics on the share of private enterprises in total industrial production are, however, puzzling. Their share went up from 33.1% of the total in 1994 to 41.6% in 1995, but fell to 29.7% in 1996, lower than two years before, and then increased again to 37.4% in 1997 (Goskomstat, 1997b: 34-5; The Socio-Economic ..., 1998, no. 31: 24). The trend in the number of industrial workers employed by private firms is analogous. It is strange that such a big drop took place between 1995 and 1996 when privatisation was in full swing. This reduction has been compensated for by a growth in the share of enterprises of mixed property, while the share of state enterprises has continued to decrease through all the years considered.

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<sup>3</sup> An official publication edited by the government of St. Petersburg gave a figure of 33.2% as to the industry's share of the city's GDP in 1996 (City of Saint Petersburg 1996, 1997: 5). However, we will consider - 30.4% - being the same figure as the one provided by Goskomstat (1998b: 10).

<sup>4</sup>These numbers do not take into consideration small enterprises and joint-ventures.

In spite of job losses in industry, official unemployment remained extremely low, at 1.9% in March 1997 (The Socio-Economic ..., 1997, no. 26: 3), and even decreased to 1.2% in March 1998. This is 2.3 times lower than the analogous figure for the whole of Russia (The Socio-Economic ..., 1998, no. 32: 3). However, one must bear in mind that a great number of workers made redundant do not bother to register as unemployed because unemployment benefits are extremely low and, therefore, are not included in the statistics. Official figures fail also to take into consideration the number of workers who are employed, but are on forced vacations, and those on reduced working time. Fourteen per cent of the workforce in St. Petersburg was for some periods of the year on administrative leave in 1996, and 10% in 1997, while 6% were partially employed in 1996 and 3.8% in 1997 (The Socio-Economic ..., 1997, no. 31: 4). According to the rules of the International Labour Organisation unemployment was in reality 9.8% in the city by the end of 1996 (City of Saint Petersburg 1996, 1997: 6). In addition, many workers, although employed, are not paid: wage arrears in industry in St. Petersburg amounted to 386 million roubles (\$60 million) at the end of May 1998 (Promyshlennyi Vestnik, 1998, no.5: 9), which corresponded to approximately 500,000 monthly wages. On average every industrial worker was due slightly more than one month's wages in arrears, which is a very low figure compared with other parts of Russia.

1997 was a pivotal year for St. Petersburg's industry. After five years of decline, total industrial output increased by 9% compared with 1996. Official data show that industrial production in large and medium enterprises rose by 8.1% (The Socio-Economic..., 1997, no.31: 13), suggesting that output increased more in small industrial firms. 1997 was followed by a year in which industrial production declined by 0.3% (Goskomstat, 1999: 3). However, this lack of growth was, to a large degree, the result of the economic turmoil following the decision of the government to stop servicing its debt. The food sector registered an increase in output in both 1997 and 1998 for the fourth year in a row, but the best performance in 1997 was registered in the main industrial sector of St. Petersburg -

machine-building and metal working - (an increase of 19.2%). However, this performance was not repeated the following year (a decrease of 6.2%), so it is not clear whether a widespread restructuring process is taking place in this sector. On the other hand, the downward trend in light industry continued, with a drop of 12.7% in 1997 (The Socio-Economic ..., 1998, no. 32: 9) and 17.6% in 1998 (Goskomstat, 1999: 10). There was also a rise in investment of 4% in 1997 and 9% in 1998, but in 1998 they still amounted to only 33% of the 1992 level (Korotkova, 1998: 6; Rybakov, 1999: 8), which was itself much lower than the year before. The rise in 1997 was mainly due to the growth by 30% of foreign investment, which accounted for one-seventh of the total investments in 1997 (Zhelvitskii, 1998: 16), while in 1998 the growth in foreign investment was 12% (Rybakov, 1999: 8). While in 1996 GDP contracted half as much (-10%) as the decrease in industrial output (-20%), implying that the output reduction in the service sector was "just" 5%, in 1997 industry fared better than services. The GDP contraction of 0.3% in 1997 (Goskomstat, 1998b: 3), despite the strong performance in industry, implies that services again contracted by approximately the same percentage as in 1996<sup>5</sup>. However, the fact that in 1997 industry still accounted for 30.4% of the city's GDP, the same figure as in 1996, despite the divergent trend in industrial and service sector performance (Goskomstat, 1998b: 10), suggests that there are substantial inconsistencies in the calculations of the respective figures. The contribution of industry has subsequently increased to 33.1% in 1998 which is line with its performance in relation to the total GDP in that year. What is strange is that in the official statistical booklet published in 1999 the share of industry in the city's GDP for 1997 is different (28.7% instead of 30.4%) from that indicated in the official publication one year before (Goskomstat, 1999: 9). Has a revision taken place? If so, this would make 1997 data even more contradictory in view of what is said above.

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<sup>5</sup> This is a personal calculation based on the fact that industry accounts for about a third of the city's GDP. Strange as it may seem, Goskomstat statistics for St. Petersburg do not indicate output variations in the service sector. The data on retail turnover indicate a decrease of 6.3% in 1997 and of 13.6% in 1996 (Goskomstat, 1998b: 4).

In the post-Soviet period diversification has been widespread in industrial enterprises, but success has been elusive for most. According to the Committee for Economy and Industrial Policy, 250 of the 1,000 large and medium industrial enterprises in the city, were actually bankrupt by the end of 1996 (The Socio-Economic ..., 1996, no. 24: 14). According to the official statistics, loss-making industrial enterprises in St. Petersburg formed 30%<sup>6</sup> of the total number of firms in 1996, compared with 29% in Moscow and 43% in Russia as a whole. This figure of 30%, however, seems very low. The fact that reduction in profits has gone hand in hand with the reduction in inflation arouses the suspicion that costs might have been underestimated due to low depreciation allowances because of an insufficient revaluation of capital assets relative to inflation. In 1994, when inflation was extremely high (although lower than in 1992 and 1993), profits decreased by 25.3% (City of Saint Petersburg 1994-1995, 1996: 101), but just 9.4% of manufacturing enterprises were loss-making, despite a 20% output fall that year in the industrial sector (The Socio-Economic..., 1995, no. 13: 9). In 1996 and 1997, when inflation was progressively reduced to nearly a single-digit<sup>7</sup> figure, the total profits of industrial firms decreased by 40% and by 39%<sup>8</sup> respectively compared with the year before (Goskomstat, 1997b: 83; Goskomstat, 1998b: 67).

The situation is especially difficult for defence enterprises. The number of defence companies in the industrial sector in St. Petersburg is 190, but only 70-110 are expected to survive (Bogorad, 1998a: 1; Bogorad, 1997: 1). Given the steep fall in defence procurements which is still continuing - the decrease in state defence orders in St. Petersburg in 1997 amounted to 14% (Bogorad, 1997: 1) - the only chance of survival for these enterprises has been to turn to civilian production. State orders for local enterprises began to drop in 1989, but the reduction became traumatic in 1992, when in a single

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<sup>6</sup> It must be remembered that several expenses are not tax deductible, so a balance sheet compiled for tax purposes may bear little resemblance to the real one.

<sup>7</sup> In St. Petersburg inflation was 125% in 1995 (The Socio-Economic..., 1996, no.19: 9), 21,8% in 1996 and 10% in 1997 (The Socio-Economic..., 1998, no.31: 7).

<sup>8</sup> This figure corresponds to the period January-November 1997 compared with the analogous period of the previous year.

year alone they declined by 57%, thus making conversion a matter of absolute priority (Whitlock, 1993: 21). At the beginning of the transition to the market, conversion of the defence factories appeared feasible, since a large quantity of civilian goods was already produced by these factories, and these were generally of better quality than the goods produced in the civilian sector. In Soviet times defence factories were favoured in the allocation of resources and, therefore, had more modern equipment. However, from 1992 to 1996 defence industries in Russia registered a sevenfold decrease in military production and a threefold decrease in civilian production (Titova, 1998: 2). Every second defence enterprise is on the verge of bankruptcy, as declared by the vice-president of the Parliamentary Committee on Industry, Construction and Transport (Chamber of Commerce of the Russian Federation, 1998a: 1). In 1997, on the basis of state procurements, work was assured for 900,000 workers, while the military-industrial complex employed 2.7 million people (Bogorad, 1997: 1).

Since 1992 these industries have had to cope not only with a significant decrease in defence orders, but also with the fact that actual state financing for these orders turned out to be no more than 30-40% of the amount allocated in the state budget (Kezling, 1998: 14). In 1997, for example, actual state budget expenditures were only 60-70% of the amount planned, and just 20-30% for defence expenditures (Most, 1998a: 44). Still lower is the analogous figure regarding conversion programmes which was 22.5% in 1995, 11% in 1996 and 15.5% in 1997 (Titova, 1998: 2). In addition, the absence of indications on future procurement needs from the Defence Ministry has meant that defence enterprises have been at a loss to know which lines of military production to retain and how much capacity to convert to civilian production. The lack of payment by the state for its procurements has resulted in a growth in state debt to enterprises. For the period 1994-1997 state debts amounted to 16.5 billion roubles (\$2.9 billion<sup>9</sup>), more than the value of all the state orders for 1998 (15.3 billion roubles). By the end of 1998 this debt had reached 18.3 billion roubles

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<sup>9</sup> Calculated at the average exchange rate in 1997.

(Ivanova, 1999: 1). The state is, in effect, driving what was previously the most advanced sector of the Soviet economy to bankruptcy, as by law defence firms cannot refuse to fulfil military orders. Firms declining to meet military orders are fined 50% of the value of the order. Defence enterprises, for their part, owe the state two billion roubles in unpaid taxes (\$200 million) (Titova, 1998: 2). In mid-1998 the total credits of defence enterprises were 2.1 times greater than their debts (Izriadnova, 1998. 1). There was the Presidential decree no. 880 on the reimbursement of the debt of the federal government to defence enterprises, but it has not been fulfilled, as resources for this end were not allocated in the 1998 state budget (Malinin, 1998a: 8).

As far as St. Petersburg is concerned, state debt due for completed defence orders exceeded one billion roubles (\$100 million) in 1998. The directors of the defence enterprises have proposed that the city government buy this debt at a 25% discount, but to no avail (The Socio-Economic ..., 1998, no. 32: 10). Non-military production accounted for 59.8% of the total output of defence firms in St. Petersburg by 1997, though only a few of these defence enterprises have managed to restructure successfully. Conversion in 1998 was under way in forty-eight defence enterprises, accounting for 10.2% of the city's industrial output and 25.6% of the industrial employees. These numbers testify to the excess of personnel in defence factories, which in total employed 174,000 people in 1998 (The Socio-Economic ..., 1998, no. 32: 9-10). However, being incapable of paying competitive wages, they have lost their most highly-qualified workers. Restructuring was made more difficult by the fact that until 1998 many of these firms had been managed by the Ministry of Economics. For this reason directors had limited managerial powers and had to wait for the approval by the Ministry for important decisions. An agreement between the federal government and the city of St. Petersburg was signed in 1998, giving the latter the power to manage these firms and carry out the restructuring programmes discussed in section 4.5.

### **4.3. THE POLITICAL SITUATION IN ST. PETERSBURG**

St. Petersburg has a federal status in accordance with the constitution of the Russian Federation. This means that St. Petersburg, like Moscow, has a status equivalent to that of the other eighty-seven subjects of the Russian Federation listed in the constitution. In the early transition years the power of local authorities was severely constrained by the lack of a clear division of jurisdiction between St. Petersburg and the federal authorities. An agreement on this subject, for which the previous mayor - Sobchak - had vainly campaigned for years, was finally signed by the Russian President not long after the election of the new mayor Yakovlev in 1996. The agreement gives St. Petersburg more powers in the local fiscal policy, in the management of city property and in the determination of the authority of local governing bodies and the procedure for their formation (The Socio-Economic ..., 1996, no. 21: 2). The city is divided into twenty administrative districts and five boroughs, the heads of which are appointed by the mayor.

This last prerogative has been seized upon by the legislative assembly in order to redress the balance of power between the representative power held by the city assembly, and the executive power which rests with the mayor's office and the government of St. Petersburg. The balance of power between the legislative and the executive authorities was reformed in 1993 by a Presidential decree in favour of the latter, shortly after the revolt of the Russian Parliament was quashed. This applied to both local and national authorities. The signature of the mayor became compulsory on legislation adopted by the city assembly before it becomes law and legislators were stripped of a salary (with the exception of the chairman and his two deputies). The clear intention of this last measure was that, obliging legislators to hold a full-time job would give them less time to dedicate their attention to the work of the assembly. The mayor acquired the right to veto legislation approved by the assembly, which could only be overruled by a two-thirds majority. St. Petersburg's politics being rather divisive, the two-thirds majority is extremely difficult to attain. By contrast, the mayor's

directives had to be sent to the city assembly for suggestions, but could not be invalidated, except by judicial process, a right previously held by the assembly.

In St. Petersburg the relationship between legislative and executive power has always been tense. As the elections for the assembly and the mayor are held at different times, the mayor is not assured of a majority in the assembly. Sobchak, who was elected in 1991 on a liberal platform<sup>10</sup> - the first mayor of Leningrad not belonging to the Communist party - soon after his election moved his office from the building housing the city soviet (renamed the city assembly in 1994) to Smolni, the Communist Party headquarters. This was the prelude to his efforts to concentrate power in his own hands and emasculate the legislative assembly, while the soviet nomenklatura was largely absorbed in his administration. The very person who led the fight against party apparatchiks came to rely on the bureaucratic means of governance typical of the Soviet period. As early as November 1991, Sobchak was calling for a new election of the soviet, even though both he and the soviet were pro-reform. Between his election and the disbanding of the soviet in October 1993, each overruled or ignored the actions of the other, generating a confusion over the validity of both the mayoral decrees and the soviet laws. More than 160 mayoral decrees were overturned by the assembly on the grounds that they violated the law, while the mayor purported that the soviet acts had no juridical force (Ortung, 1995: 48). The majority of these disputes concerned the redistribution of property. The legislative assembly elected in 1994 also had a pro-reform orientation, but this did not bring about an improvement in the relationship with Sobchak, nor with the new mayor.

In order to restrict the power of the executive in January 1998, the legislative assembly approved the city charter, which was finally signed by

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<sup>10</sup> Since the beginning of perestroika Leningrad has always been at the forefront of economic reforms and political changes in Russia. Leningrad was one of the three cities which elected a democratic council in the municipal election of March 1990. The name reverted to St. Petersburg in June 1991, following a referendum promoted by the mayor of the time - Sobchak.

the new mayor, Yakovlev, a few weeks later, following the failure of his attempts to reverse the act. Already by 1996 St. Petersburg was the only subject of the Russian Federation without a formal charter of government. The charter of St. Petersburg represents the constitution of the city, which by law takes precedence over any other legal acts regarding St. Petersburg (The Socio-Economic ..., 1998, no. 31: 1). According to the Russian constitution, the charter can be adopted by the legislative assembly without the consent of the executive branch. The charter restricts the mayor's right to rule by decree, modifies the status of the law-makers from part-time to full-time, prohibits lawmakers from working in business while in office and creates a new regional high court, called the Charter Court.

Under the previous system the executive branch had the right to approve laws with little or no legislative oversight, which created the conditions for widespread abuse of power. For example, some legislators were in charge of commercial enterprises which were very much dependent on favours from the City Hall. A ruling by the St. Petersburg municipal court declared the approval of the Charter illegal in July 1998, but the Russian Supreme Court overturned this decision, putting an end to the efforts of Yakovlev to invalidate the document. With the help of his allies in the assembly, he was trying to have approved a law which would reverse the powers established by the charter. The assembly itself is divided into two factions, for and against Yakovlev and this is paralysing any activity. Following the approval of the city charter, during the whole of 1998 there was a battle between the assembly, which did not approve legislation put forward by the mayor, and the mayor, who refused to sign the laws approved by the assembly. In the first half of 1998 he vetoed twenty laws. The liberal majority - twenty-nine seats against twenty-one pro-City Hall - returned in the last legislative election of December 1998 means that the city charter is probably safe, unless the divisions in the two liberal parties play into Yakovlev's hands.

The election campaign was characterised by a barrage of attacks from the local media against the main liberal party, Yabloko, which strongly opposes

Yakovlev, despite having supported him in the mayoral election in 1996 and despite having had one of his representatives as head of the Committee for Finance of the city government until early 1999. This party was even described in the main television channel of St. Petersburg as part of a Western plot to colonise Russia. Dirty tricks were utilised to weaken the re-election chances of the most vehement opponents of the mayor. They had to compete with candidates bearing their same name or the name of their party colleagues. These attempts, however, failed and most of the candidates targeted by this smear campaign were elected

In St. Petersburg most of the media are under the control of the city administration. Only a few newspapers are really independent and these are generally the newspapers owned by foreign investors. All the others - this means almost all Russian-owned newspapers - are owned by the city and/or subsidised by the city government or banks associated with it (Bershidsky<sup>11</sup>, 1998: 9). The few which are not pro-city hall are subject to strong pressures to align. For example, when a journalist from the political bureau of a weekly paper "*MK v Pietere*" wrote critical articles about the mayor, he was fired, presumably under pressure from the local government, and similarly, when the second largest television station in St. Petersburg took a neutral stance in the conflict between the mayor and the assembly, its director was investigated by the tax authority. With regard to the main television station in St. Petersburg, one of the very first stations to take an independent stance in the times of perestroika, and for years respected for its impartial reporting which made it one of the most popular in Russia, is now firmly under the control of the administration and has lost much of its former popularity.

The city courts, like much of the local bureaucracy, are also aligned with the city administration, which has not lost a case since the election of Yakovlev, not least because he had increased funding for the city courts in 1997 despite the fact that the Russian constitution forbids local authorities from financing

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<sup>11</sup> Bershidsky, like Whitmore, writes for the St. Petersburg Times, a Dutch-owned newspaper which, like the Swedish-owned *Delovoi Peterburg*, is among the few newspapers in St. Petersburg which are not aligned with the city administration.

legal bodies (Whitmore, 1998c: 77). Even if on paper Russia is a very centralised state with police, courts, prosecutors, tax authorities and privatisation bureaucracy under federal jurisdiction, in practice these bodies are dependent on local mayors, and, therefore, tend to be loyal to them. This makes it easier for Russian regional mayors to flout the law and civil rights without much risk. The decision by Yeltsin in 1995 to give them automatic seats in the Federation Council, the upper chamber of the Russian parliament, gave them immunity from prosecution. Many heads of the eighty-nine regions of Russia have become authoritarian, ignoring the constitution and violating democratic norms, fixing elections, putting media under their control and bullying the opposition. Even in a city like St. Petersburg, which is renowned for its liberal attitudes, the current mayor has been accused of using bribery and blackmail to gain votes in the legislative assembly and of keeping the press under an iron grip; and since his election rumours of criminal connections have dogged him (Whitmore, 1998b: 8). The architect of financial stabilisation, Artem'ev (the head of the Committee for Finance since July 1996), resigned in January 1999, accusing Yakovlev of behaving like a dictator and doing nothing to rein in the influence of organised crime in the legislative assembly. He quite openly accused the mayor of colluding with organised crime, saying that criminal structures dictate the policy of the city, and lambasted the presence among Yakovlev's allies of two deputies with connections in the criminal world. He mentioned malpractice in the city's road fund and medicine procurement system, an issue already denounced by "*The St. Petersburg Times*" (Whitmore, 1999: 2). One of these two deputies was arrested by federal investigators<sup>12</sup> for running a hit squad responsible for a number of sensational murders in the city. In fact, St. Petersburg has become known as Russia's criminal capital, following a spate of high-profile contract murders, which began after the mayor fired the previous police chief for denouncing the influence of organised crime in the administration.

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<sup>12</sup> The Interior Minister, S. Stepashin, has conducted a campaign against crime and corruption in several regions, resulting in the arrest of well known officials.

#### 4.4. CITY FINANCES IN ST. PETERSBURG

The early post-communist years have been dramatic for city administrations in Russia. Not only has the economic crisis multiplied the demand for social support, and deprived the local bodies of much-needed revenues, but the withdrawal of the central state from many areas obliged them to take up new functions in times of tumultuous change. In Soviet times the role of the city government was limited. It was mostly confined to managing communal services, retail trade and housing. The control of local industry was largely in the hands of the federal government. In Leningrad in 1963 only 7.4% of industrial production, all in the sphere of light industry, was under the control of the city government (Cattell, 1968: 12). To make matters more problematic, from the beginning of 1992 a number of expenditures were shifted to the territories without a corresponding transfer of revenues. Fiscal decentralisation accelerated rapidly during 1992 and particularly 1993. Due to the lack of a standard formula, revenue-sharing arrangements and the transfer of resources from the centre were mainly the result of *ad hoc* bargaining between the centre and the regions in these years. A standardised revenue-sharing system was finally devised in 1994, but has subsequently been changed on an annual basis.

The expenditures shifted to the territories included spending on social welfare (education, health care and family allowances), cultural activities, consumer price subsidies and subsidisation of the utilities. Also all the social services provided by large enterprises are planned to be progressively transferred to the local government. The city administration found itself obliged to provide maintenance for public housing, to finance all welfare facilities, to provide social security payments and to organise the supply to St. Petersburg of much-needed commodities, as in the Soviet era (cotton from Uzbekistan in 1994 and food from the Ukraine in 1995). The situation was especially critical in 1992 when a rationing system had to be introduced and the supplies of critical items such flour were sufficient for only two or three days (Sobchak, 1993: 59). The high cost of subsidising housing

maintenance and public transport have placed a particularly heavy burden on the budget. In order to provide these services local governments had to secure an adequate revenue base, a completely new undertaking considering that taxation had been effectively unknown for three generations. Forecasting revenues was made more complicated by very high inflation and the slump in economic activity. Balancing the budget became an arduous task. Each year revenues turned out to be lower than forecast due to the collapse of economic activity, especially of industrial production, which in St. Petersburg provided the bulk of municipal revenues, while the contribution of “trade and other commercial industries”<sup>13</sup> was very low - in 1996, for example, just 12% of the total revenues (City of Saint Petersburg 1996, 1997: 17) - indicating widespread tax evasion. Revenues from privatisation only partially compensated for these losses and after 1995 became increasingly less significant. In 1996 privatisation proceeds fell by 60% (City of Saint Petersburg 1996, 1997: 18). From 1990 to 1996 the city budget was always in deficit. There was a sharp fall of 34% in budget revenues in 1992. This was followed by an increase in 1993, due to the fact that the share of taxes remaining in the city increased, but the trend was reversed between 1994 and 1996. City revenues contracted by 20% in 1994 (City of Saint Petersburg 1994-1995, 1996: 76), 11% in 1995 (Kudrin, 1997: 427) and 17% in 1996 (City of Saint Petersburg 1996, 1997: 17). Meanwhile, the share of expenditures financed from the federal budget fell in St. Petersburg by a factor of 2.6 between 1990 and 1994 (City of Saint Petersburg 1994-1995, 1996: 103). To make up for the shortfall the city had to issue bonds and take loans from local banks. The budget deficit was equivalent to 16.5% of the revenues in 1993 (Holiman, 1997: 133), about 40% in 1994 and about 24%<sup>14</sup> in 1996, corresponding to 5% of the city's GDP (Artem'ev, 1998a: 4) with the result that the municipal debt grew to 3,387 million roubles (\$590 million) by 1997 (Whitmore, 1998a: VII).

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<sup>13</sup> Probably the author - the Leontief Center - refers here to retailers, wholesalers and other services.

<sup>14</sup> These are the official figures. According to an estimation from the Leontief Center, in accordance with the internationally accepted system of classification for revenues and expenditures, the real figure for 1996 was 36% (The Socio-Economic..., 1997, no. 25: 19).

However, the city finances never reached a state of disarray as in other parts of Russia. Pensions have always been paid on time.

One of the main tasks that the new mayor, Yakovlev, took on was to put the city finances in order. Soon after Yakovlev's election, the personnel in the city administration were reduced by about 30% and housing subsidies were halved. While in 1996 the inhabitants of the city paid for about 30% of the cost of housing repair and maintenance costs (The Socio-Economic ..., 1996, no. 24: 17), this percentage should reach 100% by the year 2003. The reduction in housing subsidies, which doubled the cost of rent and utilities, caused widespread discontent in the city and almost toppled the mayor during his first year in office. 165,000 residents signed a petition sponsored by the communists to call a referendum on Yakovlev's rule. The electoral commission gave the go-ahead, but the petition was subsequently invalidated on a technicality. Housing maintenance, in a situation where the great majority of inhabitants cannot afford to pay market prices for heating and maintenance, combined with a city budget which does not have the resources to finance these services, is an explosive issue. Expenditures on housing and utilities in the 1998 city budget are planned to register a 40% reduction on the previous year (Whitmore, 1998a: VII), and are down to 17% of total budget expenditures (Financial Committee of the St. Petersburg Administration, 1998: 37). By comparison, only a few years before, in 1995, expenditures on housing and utilities accounted for 31% of the total (Financial Committee of the St. Petersburg Administration, 1998: 37).

On the revenue side more proceeds are expected from 1998 onwards through better management of the city's property. Revenues from municipal property, which accounted for about 2% of the city budget in 1993, are expected to rise to 25% in 1998, mostly due to increased rents of residential premises and stricter control on land which has been rented. Data on two districts of the city indicated that in 1997 up to half of the municipal land utilised was not paid for (Ekonomika i Zhizn': Sankt Peterburgskii Regional'nyi Vypusk, 1998b: 6). Favouritism has been rife in the

assignment of commercial buildings. In the past many commercial buildings belonging to the city were rented at very low prices to local entrepreneurs, who then sublet them for huge mark-ups. It was customary for Sobchak to issue personal directives allocating buildings to specific individuals and organisations without the knowledge and approval of the city soviet. The soviet on discovering these irregularities, would try to invalidate the directives, but it is almost certain that not all were discovered (Holiman, 1998: 271). The month before he was assassinated - August 1997 - the city's deputy mayor, Manevich, proposed to the city assembly a law which would radically modify the way in which the city let its municipal property. Rents would be brought into line with market prices, which would be determined according to the function and location of the property. An independent commission would monitor municipal lettings. This law is considered to be one of the main motives for Manevich's assassination. In spite of the assassination, the law on rents was approved in September 1997 and came into force on 1 January 1998, but it is hard to say whether favouritism has ended. Manevich's murder could also have been connected to the struggle for state assets. Privatisation has been riddled by abuses, for which, for example, the vice-director of the City Property Committee was arrested in 1993. Intimidation of bidders at auctions was widespread, and the criminal fraternity engaged in frequent reprisals against those who sought to minimise their influence: for example, the director of the Department of Privatisation was brutally beaten in 1993. As director of the City Property Committee, Manevich oversaw the privatisation process in St. Petersburg, and had criticised the local privatisation process in which city centre properties had been sold at extremely low prices based on rouble valuations from 1991. In 1997 shops in the very centre of the city were still being privatised at 1991 prices, that by this time were equivalent to just a few hundred dollars (Borisova, 1997c: 24). Before his assassination, Manevich prepared reforms to end this abuse.

A successful \$300 million Eurobond issue (fully subscribed) was carried out in 1997 in order to restructure the municipal debt, which was mostly owed

in municipal bonds at a high interest rate and, to a lesser extent, expensive short-term loans from local banks. This in turn gave them leeway to pressure the city government for special treatment. One-third of the debt in municipal bonds and the entire debt to the banks was repaid the day after the Eurobond subscription. Due to the rescheduling of its debt, servicing the debt of St. Petersburg fell from 14% of the budget expenditures in 1996 to 7% according to the draft budget of 1998 (Financial Committee of the St. Petersburg Administration, 1998: 37).

In 1998 St. Petersburg became the first Russian city to have a treasury system for public funds. All the budget funds of the city were ordered to be transferred to the St. Petersburg branch of the Central Bank of Russia in September 1998 (Silina, 1998: 50). They were concentrated into a single account so that the treasury department can keep the city's monetary flows under control, whereas previously each committee of the city government had a separate account. A small number of authorised banks had been empowered since the early 1990s to hold budgetary accounts and service government payments for the St. Petersburg administration, as well as for the Russian government and for the administrations of the other eighty-seven regions and republics of Russia. This, which should have been a temporary measure until a treasury system for public funds was to be set up, turned out to be a long-standing practice which has allowed well-connected banks to make handsome profits. Handling a municipal or federal account assures a steady flow of funds at low cost and financial security for a bank. It was not rare for money allotted by the local or central administration for specific purposes to be delayed by these banks. In the highly inflationary years this meant having free funds which could be lent at very high interest rates.

In 1997 the city managed to collect 96.2% of the planned revenues and fulfilled 96.1% of the planned expenditures, much higher rates than in the previous years (The Socio-Economic ..., 1998, no. 32: 10). Total tax revenues in 1997 amounted to 30.7% of the St. Petersburg GDP, but 38.6%

of all revenues went to the federal government (Goskomstat, 1998b: 64). Considering only the share of revenues going to the city, they accounted for 18.8% of the city's GDP, almost 3% more than in the previous year, when the figure was 15.9% (The Socio-Economic ..., 1997, no. 25: 19). The deficit of the city budget was equivalent to only 5% of revenues. St. Petersburg is one of the twelve regions of the Russian Federation which are net donors to the federal budget, the others being mostly oil or gas producing regions. According to data provided by the city one-and a-half times more taxes are sent to Moscow than are spent by the federal government in St. Petersburg (Strateghiceskii Plan Sankt-Peterburga, 1997: 22).

In 1998, according to preliminary data, revenues were 6.5% lower than planned due to the economic crisis, but a budget surplus was recorded. A deficit-free budget has also been approved for 1999 (Government of St. Petersburg-B: 1). St. Petersburg was the only region of the Russian Federation which posted a budget surplus in 1998 (Ekspert, 1999: 36). Ninety-five per cent of revenues collected in the first part of the year came in cash and just 5% in the form of promissory notes, a very favourable percentage compared with other regions. In some regions over 70% of the total amount of taxes is paid in kind rather than in money (Russian Economic Trends, December 1997: VIII).

As a result of the financial reorganisation, St. Petersburg was one of the few regions not to default on its debt. It was declared Russia's most creditworthy city by Goldman-Sachs and won praise from international credit rating firms such as Fitch and Standard and Poor (Sindelar and Withmore, 1999: 1). The question now is whether the same financial policy will be pursued following the resignation of Artem'ev in January 1999.

#### **4.5. LOCAL ECONOMIC DEVELOPMENT POLICIES IN ST. PETERSBURG**

St. Petersburg has been at the forefront of economic reforms in the Soviet and post-Soviet period alike, frequently devising its own policy of development. Large and medium scale privatisations were also conducted in a different fashion from the standard method utilised in Russia. The city was one of the four territories to be given special rights in the privatisation of firms under federal jurisdiction (Rutland, 1994: 1113). City authorities have exploited this by taking an active stance. The local Committee on state property is one of the few in Russia which has taken on the burden of developing plans for the privatisation of large industrial enterprises, sometimes rejecting those endorsed by enterprises' managers and workers. The Committee tried to limit the percentage of voting stock purchased by managers and workers. Privatisation for cash was encouraged. However, Holiman (1997: 275) suggests that this was often done to favour buyers of whom the committee approved of, regardless of suitability. In addition, a considerable amount of revenues from privatisation were never transferred to the local budget (Holiman, 1997: 277).

Small scale privatisation<sup>15</sup>, which in Russia is under the control of municipal authorities, was carried out in St. Petersburg by selling small businesses mainly unconditionally and directly to worker collectives and individual investors or, in cases where specific employment or investment guarantees had to be complied with, through commercial tenders. As of 1 January 1997, small scale privatisation was almost completed as 97.2% of all small enterprises had been privatised (The Socio-Economic ...., 1997, no. 25: 23).

In St. Petersburg, notwithstanding the different economic strategies pursued by the two mayors who ruled in the post-communist period, both have

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<sup>15</sup> In line with the federal law, small businesses - defined as having a maximum of 200 employees and a capital value of under ten million roubles at January 1992 prices - were privatised according to different rules from medium and large enterprises.

striven to create a more business friendly environment than elsewhere in Russia by setting a profits tax which is among the lowest in the Russian Federation, introducing a limited (by Russian standards) number of taxes, and giving to privatised enterprises property rights on land and buildings, while the tax burden has been progressively switched to resources such as real estate.

In Russia property rights regarding land are still an area of great uncertainty. At first the privatisation programme gave enterprises the right only to lease the building and the land plot on which their premises stood. Subsequently, in July 1994 a Presidential decree allowed enterprises to purchase and sell land, but local authorities have been, as a rule, unwilling to comply with this decree (St. Petersburg being an exception). In practice the privatisation of urban real estate is left almost entirely to the discretion of local authorities (OECD, 1995: 81). Most of the 120,000 privatised firms do not own the land they occupy, or even have a clear lease agreement<sup>16</sup>. They occupy the land under a Soviet era concept of temporary management which allows city officials to dictate how the land will be used and gives companies limited rights to sublet, sell or redevelop. Were the firms allowed to own the land, they could use it as collateral or contribute it to a joint-venture. Only a few regions (St. Petersburg, Samara, etc.) have taken matters in their own hands, taking the initiative to sell land. St. Petersburg was the first city in Russia to do so. In St. Petersburg privatised enterprises have been given the opportunity to buy the buildings they occupy and to become the owners of the land on which their premises stand. One of the main reasons for this was the expectation that the sale would bring additional revenues to the city. The privatisation of other state-owned land is not yet allowed. The sale and rent of land plots for privatised enterprises was regulated by the decree of the mayor of St. Petersburg no. 1049 of 19 October 1994. In 1996, 828 privatised enterprises bought the land they occupied (City of Saint Petersburg 1996, 1997: 4) and in the first half of 1997 a further 700 (Iasinskaia, 1997: 6). However, the high prices, coupled with the precarious

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<sup>16</sup> Less than 1% of the land space occupied by these companies was privately owned

situation of most industrial companies and the complexity of the procedure, has ruled out this option for most firms. Approvals are needed from a number of local bodies (the Committee for Town Planning and Architecture, the Committee for Land Resources and the Department of the State Inspectorate for the Protection of Historical Monuments), making the procedure difficult and time-consuming. In addition, the registration of the property deeds can take up to six months or a year after the sale has been concluded (Iasinskaia, 1997: 6). A system for the registration of property deeds for land and real estate had to be implemented from scratch, since the Soviet Union had no land registration or survey system.

As far as local taxation is concerned, St. Petersburg maintained the portion of the profits tax going into the local budget at 22%, even after the enactment of the law in 1993 allowing local authorities to increase it from up to 22% to up to 30% for banks, brokers, insurance companies and companies engaged in intermediary services and transactions<sup>17</sup> and up to 25% for all the other categories of enterprises. The portion of the profits tax going into the local budget was subsequently reduced to 21% in 1995 and 20% starting from 1997, following the approval by the city assembly of the law "On Some Issues of Taxation in the Years 1997-1999" (10 November 1996). For banks and the other aforementioned entities, it has stayed at 22%. As a comparison, the profits tax in Moscow was 22% and 30% in 1995. However, the surrounding region - Leningrad - has set even lower rates of the profits tax in an attempt to entice the city's companies to relocate in the region (Zatsepin, 1997c: 9). From 1999 the local profits tax in St. Petersburg is to be lowered further to 19% - this time the decrease was dictated by federal law - while no change is foreseen for the higher rate and according to a local draft law it will be reduced to 18% in 2000 and 17% in 2003. The main purpose of the law "On Some Issues..." was also to reduce the number of tax privileges for specific enterprises, which are very costly for the local budget, but whether tax concessions have, in effect, decreased in

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according to statistics of the State Property Committee (The St. Petersburg Times, 1996).

<sup>17</sup> An intermediary is considered to be an agent who receives a commission for deals concluded among other parties rather than a trader.

the following years is unclear. It must be kept in mind, however, that the lower rate of the profits tax in St. Petersburg compared with the other parts of Russia represents only a partial benefit because many business expenses remain non-deductible and the sheer amount of taxes makes the total burden very high, notwithstanding St. Petersburg's restraint in the introduction of taxes. Of the twenty-one local taxes which by law local bodies were allowed to introduce, St. Petersburg had introduced only thirteen by 1995 (Ipatova, 1996: 10).

In addition to the profits tax the main taxes are the tax on housing and socio-cultural facilities and the road tax, both at 1.5% of the sales revenues (VAT excluded)<sup>18</sup>; the latter is 0.11% for retailers and wholesalers. There are also taxes on wages of Russian employees, such as the contribution towards educational institutions (1% of total wages and salaries) and the payments to various social welfare funds (accounting for about 40% of total wages and salaries); a tax on business property of 2% of the property value, etc. These rates were equivalent to the standard rates in Russia in 1997, but the road tax was reduced to 1% starting from 1 July 1997 and the contribution towards educational institutions was cancelled in the following year, as envisaged by the law "On Some Issues...".

Following the Soviet downfall the city lost its importance as a defence centre, raising fears of a progressive de-industrialisation, and new strategies for the future of the city had to be devised. The favourite strategy in the early 1990s envisaged the transformation of the city into a free economic zone with favourable legislation on foreign investment. At the time this was seen as a possible panacea for the economic problems plaguing the city. It was naively believed that foreign investment would flood into St. Petersburg as a consequence of the advantageous conditions set up in the city, which was to become the window to Russia for investors anxious to exploit the opportunities created by the economic transformation. The city

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<sup>18</sup> The tax on housing and socio-cultural facilities and the profits tax can be decreased by the amount spent by an enterprise on health, education, culture, sports centres and kindergartens up to a maximum of 5% and 6% respectively.

was to revert to the functions it had prior to the revolution when it was an international business and financial centre. Leningrad was declared a free economic zone by a Degree of the Supreme Soviet of the Russian Federation on 14 July 1990 "On the Creation of Free Enterprise Zones". However, this project did not go any further. The idea of granting tax concessions and special customs conditions to such a big city did not prove viable. The idea of a free economic zone was, therefore, reduced to a strategy for selected areas, as stipulated by the new programme for the socio-economic development of the city called "St. Petersburg-2000", prepared in 1993-94 by the Committee on Economic Reform of the city administration and the Leontief Center. Thirteen sub-zones were planned with different functions: customs, warehousing, production, services, R&D. The advantages offered by these encompass reduced tax rates, a simplified customs regime and more flexible currency regulations. There is a fundamental difference from the free economic zone concept in the other parts of the world, which consists of a purpose-built area set up to accommodate firms under given conditions. St. Petersburg FEZs are set up on the basis of concrete projects agreed between the local government and the prospective residents, as the realisation of a standard FEZ would entail the expenditures of an amount of resources that the city could not afford. These projects are financed by initiators of the zones, who in exchange receive tax concessions for a given period of time. Initiators can be both Russian and foreign legal entities and Russian and foreign individuals. The department in charge evaluates the projects and proposes the tax concessions to be granted, within its own share of the tax revenues. The most important factors taken into consideration are the increase in industrial production and budget revenues that these zones are forecast to bring about in the coming years. If these commitments are not fulfilled, the resident enterprises must refund the privileges they received.

The first three FEZs began to function in 1994. The export-oriented sub-zone Pusckinkaia is dedicated to the production of construction materials and household appliances. The customs sub-zone Severnia Verf consists of premises for cargo storage and handling and processing of import-export

goods. The customs sub-zone Gavan, based in the exhibition complex Lenexpo, has as a sphere of activity the realisation of exhibitions and the storage and processing of export-import goods. In 1995 a fourth sub-zone, Polustrova, was set up, which has a wider profile of activity: the construction of customs, industrial and commercial infrastructure and the carrying out of commercial and industrial activity (Nikiforov, 1995: 4). Eleven additional zones in the city were approved in 1996 by the Committee for Economy and Industrial Policy. By the end of 1997 the first three zones to come into existence had created more than 700 jobs, attracted investments of more than \$13.2 million and paid \$4.1 million in taxes (Government of St. Petersburg-A: 12). As a result, despite the relative success of these zones, FEZs have ended up having only a marginal role in the city's economy, contrary to the enthusiastic expectations of the early 1990s.

Making St. Petersburg an international business and financial centre, however, remained the main objective of Sobchak, the mayor who governed from 1991 to 1996. The development of advanced banking, transport, customs, telecommunications and tourist infrastructure was planned, but given the financial difficulties of the city this was impossible to realise without a substantial contribution from outside capital. St. Petersburg, despite handling about 30% of imports and 20% of exports of the Russian Federation (Centre for Finnish Business and Policy Studies, 1996: 10), has a transportation system in great need of improvement, plagued by long queues at border points, poor roads, inadequate and very expensive port facilities, etc. It is common for Russia-bound cargo ships to be unloaded in Finland and the goods transported by road to Russia. The most significant investment projects carried out during Sobchak's tenure were the modernisation of the international airport, the improvement of the railway route between Moscow and St. Petersburg and the road connections with Finland and Poland, but other projects such as the construction of a new harbour had to be mothballed for lack of finance.

International events were organised such as the Goodwill Games and the annual EBRD meeting at which several projects were presented to foreign investors, but ultimately these events turned out to be a drain on the scarce resources hardly justified by the results. The EBRD declared St. Petersburg to be their top priority in Russia, which led to the financing of some projects in real estate and banking and to the restructuring of a few local industries (Katz, 1994), but overall the total amount of foreign investment was very disappointing, considering the great expectations, and fell substantially below the amount received by Moscow. The attempt to transform St. Petersburg into a banking centre also failed, despite the setting of a profits tax for financial institutions much lower than in the rest of Russia. All the major Russian and foreign banks are concentrated in Moscow. At the end of 1996 there were 844 commercial banks registered in Moscow, and only fifty-six in St. Petersburg (Strategic Plan for St. Petersburg, 1998: 22).

The new mayor, Yakovlev, elected in mid-1996, changed the approach of the city government declaring that the first priority was to revive the city's industry by exploiting the high-technology potential of the defence sector<sup>19</sup>. The transformation of St. Petersburg into a strategic financial and business centre still ranked as a priority, but below the revival of local industry. Unlike his predecessor, he placed less emphasis on foreign investment given the disappointing inflow of foreign capital in the first half of the 1990s. He favoured a more interventionist approach criticising the policy of his predecessor whereby industry was left to develop with little involvement from the local government (Deviatovoi, 1999: 4).

The guideline for the new economic policy was established by the "Programme of Stabilisation and Subsequent Development of the Economy of St. Petersburg in the Years 1997-2000", while the long-term strategy for the city was spelled out in the "Strategic Plan for St. Petersburg". The first was worked out by the Committee for Economy and Industrial Policy in

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<sup>19</sup> The revival of industry exploiting the technologies of the defence sector has been a popular catch phrase which, however, provides few indications on how this will be achieved.

1996, then headed by D. Sergeev, and the second by the Leontief Center together with the city administration and the main business and scientific organisations of St. Petersburg in 1997. A total of 168 organisations participated in the formulation of the Plan. Fourteen commissions were formed to analyse the policies to be approved, and in the end 211 proposals were selected.

The main difference is that the programme puts the emphasis on the revival of local industry. In particular, it envisages restructuring the defence complex and the reorganising of the shipbuilding enterprises - the three major shipbuilding firms of the city are planned to be merged (Korotkova, 1997a: 1) -, while the plan stresses the need for the integration of St. Petersburg into the world economy.

The Strategic Plan approved on 1 December 1997 lists a long set of measures which if implemented should, in the expectations of the plan's formulators, result in the creation of 200,000 new jobs, an increase in the real income of the population of not less than 15%, an increase of three years in life expectancy and a rise in budget revenues of not less than 20% in real terms, though it is not specified when all this will take place and how these figures were calculated (Strategic Plan for St. Petersburg, 1998: 103). Future spending in the city budget should be in line with the priorities established in the plan. The main objective of the plan is "the development of St. Petersburg as a multifunctional city integrated into the Russian and world economy and providing a favourable environment for life and economic activity". It particularly emphasises the strengthening of St. Petersburg "as the major Russian centre for contact between the Baltic Sea region and the North-West of Russia" (Strategic Plan for St. Petersburg, 1998: 5) and aims to transform St. Petersburg into the most important transport and commercial hub connecting Europe and Asia<sup>20</sup>. Following the dismantling of the Soviet Union, Russia lost half its ports and St. Petersburg remained the only major Russian port on the Baltic Sea, except for

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<sup>20</sup> Some of the expectations are clearly far too optimistic at the present stage.

Kaliningrad, which is separated from the rest of Russia by Lithuania. In order to enhance the development of St. Petersburg as a transport centre there are plans to build a ring road around the city, to reconstruct the sea and river ports and their terminals, to build a Helsinki to St. Petersburg highway, to create additional free economic zones, etc. An advantageous taxation system will be conceded to goods in transit (Zatsepin, 1997b: 9). It is expected “the switching to St. Petersburg of no less than twenty million additional tons of cargo out of the total volume of Russia’s foreign trade [and] the development of related industries” (Strategic Plan for St. Petersburg, 1998: 103), which sounds very optimistic considering the dismal reputation of the port. High port fees, excessive bureaucracy and inefficiency do not make the port competitive with those of nearby countries. Despite the emphasis of the local administration, St. Petersburg is not developing as a transport centre. From 1992 to 1996 freight turnover decreased more than the corresponding decrease in production, while in 1997 it was stable and in 1998 declined (-3.9%) (Travin, 1998: 5; Goskomstat, 1998b: 3, 53; Goskomstat, 1999: 3).

The plan envisages the creation of a “maximally” favourable business environment “which stimulates economic growth and becomes the main factor in attracting resources and investments to St. Petersburg” (Strategic Plan for St. Petersburg, 1998: 45). The plan’s proposals are to reduce the tax burden for industry, to eliminate constraints on business creation, to implement an anti-monopoly policy, to provide incentives for investment and to create equal conditions for all economic entities by eliminating privileges and exemptions.

For example, licensing procedures were designed to be made simpler and more transparent (Strategic Plan for St. Petersburg, 1998: 66). In effect, a single licensing body was finally created in St. Petersburg in 1999, while before various local administrative bodies had the power to grant licences and the different practices of these bodies, coupled with differing methods

of calculating fees, greatly complicated the process of applying for such licences.

To assist the industrial sector, the Plan foresees the organisation of retraining programmes for management and the sale of state-owned shares to strategic investors (Strateghiceskii Plan Sankt-Peterburga, 1998: 50) - a rather unoriginal position, reflecting the hopes of the early 1990s that foreign investors would restructure domestic industry - as the poor competitiveness of many industrial enterprises is attributed by the Plan to technological backwardness and weak management. Support is also envisaged for the creation of financial-industrial groups, which are seen by the plan's formulators as a method of favouring growth in the industrial sector (Strateghiceskii Plan Sankt-Peterburga, 1998: 50), in the conviction that by linking enterprises and banks, exchanges will be facilitated and resources reallocated among them, helping each firm to stay afloat.

Some points of the Strategic Plan, such as the "transformation of St. Petersburg into a centre of higher education for all regions of Russia, the CIS countries and a number of developing countries, and into the major international centre for study of the Russian language and culture" (Strategic Plan for St. Petersburg, 1998: 103), seem to be, however, merely declarations which do not envisage a clear set of measures to achieve their targets.

Financing for many of the projects advocated by the Strategic Plan is currently lacking, but the city has created a guarantee fund of 1.3 billion roubles (\$230 million at the 1997 exchange rate), which can cover bank loans aimed at investment projects corresponding to the priorities established by the Programme of Stabilisation and the Strategic Plan. The guarantee can be up to 50% of the total investment. About 300 requests for guarantees were received in 1997 (Fedorov, 1997: 2). Tax concessions<sup>21</sup>

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<sup>21</sup> This law allows firms to deduct from taxable profits sums used for investment in both the production and non-production spheres, and also the interest paid to the bank for loans used for capital investments. The deduction applies only to the portion of taxes going to the

were also introduced for investments of more than \$5 million (law approved by the city assembly on 8 July 1998). In addition, the mayor was relying on the state acting as guarantor for some projects in order to receive loans from European banks at a lower interest rate. A decree on this matter was expected to be issued by the President (Zatsepin, 1997b: 9), but the effective insolvency of the Russian state has ruled out this option.

The Plan hopes that the investment programme of St. Petersburg for the years 1998-2001 will be realised in part by foreign investors. However, problems such as corruption and red tape, which are rife in the city, need to be tackled in order to attract a sizeable amount of foreign capital. The Leningrad region<sup>22</sup>, surrounding the city, has taken advantage of the poor reputation of St. Petersburg and has been selected by a number of foreign investors such as Philip Morris, Caterpillar and Ford, since the local government there is renowned for being more business-minded and making business decisions faster than in St. Petersburg. St. Petersburg is highly centralised. All important decisions are made by the city government, but the enforceability of such decisions is sometimes a problem. In the surrounding region the administration is more decentralised, leaving the towns with more autonomy and less bureaucracy.

The Programme of Stabilisation devised in 1996 went into considerably more detail on the city's industrial policy than did the Strategic Plan. According to the Programme, the local administration must take an active role in selecting industrial firms to assist. The target is to reach by the year 2000 68% of the level of industrial production recorded in 1991 (98% for consumer goods) (Sergachev, 1996: 8). These industrial firms are to be given priority in the allocations of municipal procurements, especially those belonging to the food processing, light industry and construction material sectors. According to a law proposed to the legislative assembly in 1999 the city administration should be legally bound to buy domestic goods if their

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city budget (Promyshlennyi Vestnik, 1998: 9).

<sup>22</sup> While the city of Leningrad changed its name to St. Petersburg in 1991 the surrounding region has retained the old name.

price is not 15% higher than analogous foreign produce (Davlitsarov, 1999: 2). Only 25% of the municipal procurements went to city enterprises in 1998; the plan was to increase this share to 50% in 1-3 years and to 75% afterwards (Government of St. Petersburg-C: 2). All municipal procurements were planned to be assigned through open tenders, following a mayoral resolution dated 22 May 1997, however, this resolution has not been enforced. Measures to make the assignation of procurements more transparent were finally undertaken in late 1998 when a regular bulletin of the city procurements was first issued (Davlitsarov, 1998: 1), but according to Artem'ev, the head of the Committee for Finance until January 1999, almost all tenders continue to be assigned without any competition (Kotsiubinskii, 1999: 4). The director of the Committee for Economy and Industrial Policy who replaced Sergeev, Klebanov, in charge from December 1997 to June 1999<sup>23</sup>, has continued the realisation of the programme of stabilisation<sup>24</sup>; however, it is now clear that the stated objectives relating to production levels will not be achieved. The programme has been accused of being unrealistic by both the directors of the "old guard" industrial enterprises and the representatives of the liberal wing (Arkhipov, 1998: 67), while the government attributes the improved performance of industry in 1997 and 1998 to the measures undertaken in the context of this programme (Klebanov, 1999: 2), measures which will be analysed in the following pages. However, as discussed later it seems more likely that factors other than this programme have influenced the output trend.

In addition to the Programme of Stabilisation and the Strategic Plan, some sectoral programmes have been or are in the stage of being implemented in St. Petersburg, while many other programmes have been planned, but never realised. A programme for the reconstruction of the light industrial sector was devised by the city, with a budget of 500 million roubles (\$100 million) in 1996. In half of the fifty-eight enterprises belonging to this sector the

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<sup>23</sup> In June 1999 Klebanov was called to serve in the Russian government.

<sup>24</sup> He declared in 1998 that seventy-six of the ninety-two primary measures envisaged for the second half of 1998 had been realised (Klebanov, 1999: 1).

purchase of “modern equipment” was financed<sup>25</sup>, but despite this assistance these enterprises have continued to be financially weak, failing to produce enough circulating capital to buy the necessary raw materials (Bogorad, 1998a: 1).

An inter-regional programme for restructuring textile industries in North-Western Russia, called North-West Textiles, has secured financing of 800 million roubles (\$160 million<sup>26</sup>) from the federal government to be given in the form of loans, but the money has not yet been disbursed<sup>27</sup>. This programme is a pilot project within the framework of the federal programme “Russia’s Flax Complex Development”. A financial-industrial group is to be established in the area, encompassing firms cultivating flax, flax-manufacturing industries of the area, textile and clothing factories, scientific institutes and machine-building industries. However, this programme has not been well received by the directors of the clothing industries, who are sceptical of the effectiveness of uniting such a long production cycle under a single management. In their opinion, such a big corporation runs the risk of being unmanageable (Zhelvitskii, 1997b: 15).

The formal adherence to shock therapy has, in reality, masked a diffused reliance on administrative methods at federal and local level, deriving from the continued conviction that the state has an important role to play in the economy. Plans for the modernisation of various sectors are frequently elaborated. For example, the State Duma speaker Seleznyov declared the necessity of uniting industrial enterprises in the sectoral support funds with the aim of developing and carrying out targeted programmes of modernisation of the priority sectors through the concession of investment credit, tax advantages and equity participation from the state (Nevskoe Vremia, 1999: no.35). As far as St. Petersburg is concerned, an Industrial Support Fund under the Committee for Economy and Industrial Policy has

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<sup>25</sup> It is not clear what the author means by modern equipment, and there is no indication whether the finance was in the form of loans or grants.

<sup>26</sup> Calculated at the average exchange rate in 1996.

<sup>27</sup> Financing from the centre to the regions consists not only of transfers for the poorer regions, but also of special development programmes.

been active since 1994, with the responsibility for “arranging and financing priority research and production programs and projects intended for the introduction of advanced domestic work-outs [technologies], production of new competitive products, optimisation of the industrial structure” (Committee for Economy and Industrial Policy, 1). Local governments in Russia are lobbied frequently by industrial firms since the majority do not have the resources to make investment, or even, often, to pay workers and therefore frequently request assistance. Thirty-five point six per cent of industrial companies in Russia are considered bankrupt<sup>28</sup> (Strategic Plan for St Petersburg, 1998: 21). In Russia industry is suffocated both by high taxation and the costs of electricity and cargo transportation, which are set high to counterbalance the subsidised costs of domestic electricity and passenger transport. In St. Petersburg in 1996, industry accounted for 57% of the local tax revenues, but only 33% of city’s GDP (City of Saint Petersburg 1996: 1997: 5-17), and while as a norm the unit cost for electricity is higher for private consumers than for industry, in Russia it is the opposite. Electricity tariffs for industry are 50% higher than in Finland (interview with Klebanov, Griaznevich, 1998: 3). This, coupled with the high energy intensity of many local industries, has meant that in some factories the share of energy and heating in total production costs reaches 50-70%<sup>29</sup> (Kezling, 1997: 6). In addition, the massive non-payment crisis has starved enterprises of liquidity.

In Russia the central and local governments have provided financial support to the industrial sector through a variety of channels: tax benefits, directed credits and investment grants. However, there is little evidence that subsidies are aimed at sectors with long-term comparative advantage. In industry subsidisation has been aimed at regionally dominant industries in crisis, or at sectoral interest groups (Freinkman and Haney, 1997: 7), while

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<sup>28</sup> Even if it is not indicated, this figure probably includes only medium and large enterprises as official statistical data refer to these.

<sup>29</sup> It must be noted, however, that in Russia companies can avoid paying their electricity and heating bills as power cut-offs are rarely carried out. To keep the electricity companies from shutting off power supplies, the government makes up for their missing payments with a tax credit.

support for newly created firms has been limited (Halligan, Teplukhin and Willer, 1996: 118). Unusually, exemptions have often been set by Presidential decree and frequently apply only to individual companies, but since 1992 this practice has decreased. In general, there has been a reduction in subsidies from the central government since 1992, which has been accompanied by an increase, although much smaller, in subsidies from local authorities. Subsidisation of the Russian economy at federal level was estimated to be equivalent to between 41.5% and 55% of GDP in 1992, 10.7% and 17-20% in 1993, 5.8% and 7-8% in 1994 and 2.2% and 1.6% in 1995<sup>30</sup> (Freinkman and Haney, 1997: 5; Halligan and others, 1996: 111) remaining primarily to support agriculture and the coal industry, while subsidies from regional budgets were estimated to be 5.2% of GDP in 1995. Subsidies increased from 26% of total regional expenditures in 1992 to 36% in 1995 (Freinkman and Haney, 1997: 5). Despite the reduction in subsidies the category "national economy" - mostly subsidies - continued to represent the largest item of expenditure in the consolidated state budget. In 1997, for example, it accounted for a quarter of the total expenditure and 8.2% of the GDP. Approximately three-quarters of this was spent by local and regional budgets. In reality, subsidisation is larger than these figures suggest, as support by local authorities has been granted mainly through implicit subsidies which are not reflected in the budget such as tax benefits, preferential utility prices, favourable rates of asset lease and to a lesser degree through directed credits and investment grants. The main recipients have been housing, agriculture and public transportation rather than industry. In the period from 1993 to 1995 housing made up 60-65% of the total subsidies given by local authorities, agriculture 15% and transportation 7-8% (Freinkman and Haney, 1997: 5). In 1997 housing still made up about half of the total amount of subsidies at federal and local levels combined. Although 80% of the regional subsidies are directed at consumers (Freinkman and Haney, 1997: 8), these subsidies are disbursed not directly to the final consumers, but to enterprises. Enterprises not belonging to the aforementioned sectors have also received financial support, but regarding

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<sup>30</sup> The first figures are reported by Freinkman and Haney, the second by Halligan and

the amount of this financial support the documentation is sketchy. As support is provided in a variety of forms and from different sources - from the budget and from extra-budgetary funds - it is difficult to obtain a complete picture.

In the 1998 budget of the city of St. Petersburg, subsidies are the largest item of expenditure, representing 27.6% of the total (Financial Committee of the St. Petersburg Administration, 1998: 19). These are mostly in the form of grants which are conceded to subsidise the purchase of foodstuffs, agricultural raw materials, fuel and other goods in selected firms, to finance public transportation, to compensate enterprises and organisations obliged to sell their products at fixed prices established by the authorised state body, to reimburse housing organisations for losses, and for other non-specified purposes. No indication is provided as to the amount of subsidies going to industry. For this reason it is difficult to obtain a precise view of the industrial policy carried out by the city administration. In addition to conceding grants, the industrial policy of St. Petersburg was carried out by lowering the tax rate in spheres of activity whose development was deemed to be a priority and by granting tax deferments and soft long-term loans to selected businesses. However, the systematic shortfall of budget revenues compelled the administration to cancel some of the planned subsidies every year. In 1996, for example, the shortfall of revenues was about 25% at local level, compared with 30% at federal level (Zatsepin, 1996: 2). The law "On Tax Advantages" approved by the legislative assembly on 28 June 1995 lowered from 22% to 18% the profits tax for several branches of the food industry<sup>31</sup> and for health, education and cultural enterprises (Biznes-Shans, 1995: 15), on condition that the profitability of the interested company is not higher than 30% of the total turnover, and that the money saved by the lowering of the tax rate is used for investment in machinery and equipment. The intention of the administration is to promote the production of goods of primary necessity in order to make St. Petersburg more self-sufficient. Tax deferments to the value of sixty-two million roubles (\$14 million) were

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others.

given in 1995 to sixty-seven enterprises, mainly belonging to the defence complex and to light industry. In particular, tax deferments have been conceded to large firms threatened with bankruptcy in order to keep them afloat. About the same amount was estimated to be forfeited by the city budget through the reduction of the tax rates for selected activities, as explained above, according to the deputy director of the Committee for Economy and Finance (this Committee was subsequently divided into two: the Committee for Finance and the Committee for Economy and Industrial Policy) (Steschenko, 1996: 4). Light industrial enterprises also received loans for 22.5 million roubles (\$5 million) in the same year, but the efficacy of these loans seems to have been limited. The financial situation of these enterprises has not improved, since their tax debts have increased. Not a single rouble had been repaid by April 1997 (Zhelvitskii, 1997a: 20).

The most significant measures taken by the administration of St. Petersburg in 1996, 1997 and 1998 were as follows (Motyl'kov, 1996: 5; Government of St. Petersburg, 1998: 8; *Promyshlennyi Vestnik*, 1998, no.5: 9; Klebanov, 1999):

- agreements with seventeen other regions of the Russian Federation were signed by the St. Petersburg administration in order to revive trading (Strategic Plan for Saint Petersburg-monitoring). These involve an exchange of industrial products made in St. Petersburg with grain, meat, raw materials and semi-manufactured products. For example, St. Petersburg has sent Tataristan fertilisers and turbines in exchange for oil and petrochemical products.
- energy tariffs were regulated in order to keep in check their continuous rise.
- food and food processing enterprises were helped in solving the problems connected with the purchase of raw materials and the modernisation of equipment in the biggest enterprises of this sector (Xlebni Dom and Petmol) was financed<sup>32</sup>.

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<sup>31</sup> Firms producing butter, meat and non-alcoholic beverages, dairy industries and bakeries.

<sup>32</sup> It is not specified whether it was a grant or a loan.

- a State Investment Company was set up whose main aim is to carry out selected investments in “high profitable projects” in light and textile industries.
- a mutual clearing of payment arrears among industrial firms (in 1996 amounting to about 160 million roubles- \$31 million) was carried out every year to ease the liquidity crisis.
- tax postponements of 49.5 million roubles (\$10 million) in 1996, 77.1 million (\$13.5 million) in 1997 and 61 million (\$6.1 million) in 1998 were conceded.

Given the scale of the output fall in city industry such measures are of limited effectiveness, but on the other hand the city had to balance the need to help local industry with the financial constraints of the local budget. According to the director of the Committee for Economy and Industrial Policy, Sergeev, in charge from June 1996 to December 1997 these last two measures permitted a saving of 1,500 jobs in 1996 (Korotkova, 1997a: 1). The Committee also stresses that the measures undertaken in the food industry have brought about an increase in output, but fails to mention the results, if any, of the subsidies conceded to sectors such as light industry, where the output drop continues year after year (Malinin, 1997: 37). Some of the measures, such as the assistance provided to large food firms through the delivery of subsidised meat, have been criticised by small businesses on the grounds that it makes it difficult for small firms to compete with their larger counterparts (Delovoi Peterburg, 1999: 16-17). Attributing the production increase in the food industry mainly to the measures undertaken by the administration is a little simplistic. As this sector has been one of those favoured by foreign investors in the city, and the better performing enterprises are those which attracted them, the opinion of the committee seems to be groundless. In effect, a concrete vision seems to be lacking. Concessions were frequently given on an individual basis without a transparent mechanism of evaluation. The main financial newspaper in St.

Petersburg (*"Delovoi Peterburg"*<sup>33</sup>) has remarked that subsidies conceded in 1995-1996 have brought about neither an increase in tax revenues nor more employment in the firms concerned, while tax arrears in these firms have increased (Zhelvitskii, 1997a: 20). In its opinion the city policy regarding light industry has been based on the principles of supporting virtually or potentially bankrupt firms (Zhelvitskii, 1997b: 15). In an article in one of the most popular Russian financial magazines (*"Delovye Lyudi"*) the author pointed out that in St. Petersburg all the measures to support industry have entailed satisfying the requests of the most influential directors through the concession of advantages to selected industrial enterprises (Arkhipov, 1998: 67). As declared by Ostrovsky, a lawmaker who chairs the Legislative Assembly's Committee for Economic Reform, (Whitmore, 1997a: 2) recipients have often been monopolies and inefficient large-scale enterprises.

For their part industrialists have long accused the local administration of doing too little to halt the decline in production. The previous mayor, Sobchak, in particular is accused of not having had a strategy to prop up the industrial sector at a time of exceptional difficulties, but to have taken only isolated measures while concentrating his efforts on trying to transform St. Petersburg into a major financial centre (Alekseeva, 1996: 1-2).

Following the break-up of the command system the large manufacturers of St. Petersburg created the Union of Industrialists and Businessmen to maintain long-standing economic ties between enterprises between enterprises and provide mutual help. Because of this, in 1992, despite the insolvency of many enterprises, deliveries continued as before because of the desire to maintain the, but in 1993 and 1994 with the deterioration of the economy, more and more decided that they could not afford to follow these rules, and stopped abiding by them. The result was that after a few years this organisation lost its original functions and acted mainly as a lobby spurring the government to solve the most pressing problems affecting the

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<sup>33</sup> A Swedish-owned newspaper, one of the few local newspapers not aligned with the city

industrial sector: mutual non-payment as well as non-payment from the state, competition from foreign products, lack of resources to carry out investments, etc. (Interbridge, 1998: 8). The Union covers all sectors of the economy, though it is heavily represented in the military-industrial complex. It mainly represents the "old guard". It has more than 100 members and declares itself to represent industries accounting for more than 80% of the total industrial output of the city in 1997, in addition to banks, insurance companies and commercial institutions (Days of Economics of St. Petersburg, 1997: 5). Feeling alienated from the political parties, industrialists of St. Petersburg created their own party, "Industry of St. Petersburg", to contest the legislative election of December 1998. This party has among its members more than 200 directors of industrial, construction and transport enterprises, employing more than 260,000 workers. The main objectives of the party are the approval of laws on city procurements and on the promotion of investments, stricter control of the city's expenses and utility tariffs, and an increase in customs duties for foreign products (Malinin, 1998b: 1). However, they failed to win any seats.

The concession of subsidies was curtailed at the end of 1997 under pressure from the Committee for Finance, and in the 1998 city budget expenditures to support industry as well as communal services and energy were reduced, while spending for education, culture and social services was increased (Klebanov, 1999 1). Data from this Committee showed that of all enterprises receiving tax postponements only 10-15% could pay taxes back when the period of postponement had elapsed. The new head of the Committee for Finance - Artchur'ev - has criticised in particular the groundless concessions for monopolists (Predprinimatel' Peterburga, 1999, no.7: 2). The scarce benefits for the industrial sector of the measures envisaged by Sergeev led to his replacement by Klebanov, the managing director of one of the biggest industrial firms in St. Petersburg, LOMO. Klebanov is the man credited with increasing LOMO's export revenues from \$80,000 in 1992 to \$16 million in 1996, and retaining 65% of the

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administration.

Russian optics market (Whitmore, 1997/a: 2), however notwithstanding this, LOMO remains heavily in the red.

Klebanov promised to terminate any subsidies for ineffective industries, to introduce tax holidays for foreign investors and to create a favourable economic climate in order to stimulate domestic production as stated in the Strategic Plan. His policy aims at tackling general problems such as high utility tariffs, investment and tax policies rather than devising sectoral approaches (interview with Klebanov, Malinin, 1998a: 8). The concept underlying the tax policy in 1999 is to reduce the tax burden for producers and to increase it for consumers. The tax on housing and social-cultural facilities owned by enterprises was cancelled in 1999, along with some duties, while a sales tax of 5% was introduced. The concession of subsidies to industrial firms is to be linked to concrete plans of restructuring of the concerned enterprises.

The strategy to reform manufacturing enterprises in the city has been spelled out in the "Concept for Reforming the Manufacturing Enterprises of St. Petersburg", which was approved by the Committee for Economy and Industrial Policy in 1998. Enterprise directors have to submit a restructuring plan to the committee. If the plan complies with the conditions set by the city, an agreement is signed between the government of St. Petersburg and the enterprise and the latter is awarded certain privileges<sup>34</sup> which may take various forms: complete or partial tax concessions; rescheduling of debts owed to tax bodies, extra-budgetary funds and monopolists; city procurements; municipal guarantees, etc. (The Socio-Economic ..., 1998, no. 34: 13). Tax liabilities and arrears can be rescheduled over 5-7 years. As Klebanov argues, it is important to create the conditions at local level so that fiscal debts can be paid over 5-10 years, rather than request immediate payment from industries which do not have the resources to pay them back (Press Centre ..., 1998). Similarly, at federal level a rescheduling, or even in some cases a writing-off, of current tax debts is being discussed (Russian

Economic Trends, 1998, no.1: 95). The impact on the city budget of conceding tax privileges is to be offset by a reduction in capital investment, which in 1998 represented 12% of the budget expenses (Rubtsov, 1998: 4). Restructuring may involve splitting the enterprise into two or more units under a holding company, selling off excess property, or incorporating the enterprise into an existing holding. The potential for desegregating large firms into small units is great in the former socialist states, as many of these companies have been built without a market logic or employing vertical integration even if it was inefficient. They have many auxiliary services which could be contracted out and often turn out a great deal of different products which bear little or no relation to each other. There are, therefore, a great deal of production processes which are likely to be underutilised because they were set up under communism in order to assure the availability of the necessary inputs to the enterprise where they are located, given the unreliability of the supply system. For this reason it makes sense, according to the Committee, to divide them into separate firms, each concentrating on a specific activity. Various large industrial enterprises in St. Petersburg had already been divided along divisional, factory or departmental lines before the programme was adopted, but the results of this process so far in St. Petersburg have not been generally successful, as the equipment is old and these enterprises usually lack the financial resources to make new investments. For instance, the Kirov factory, one of the Soviet Union's leading defence firms, created in 1993-94 about seventy financially independent entities, but some had to be subsequently reunited as they were unable to stay afloat. Notwithstanding the not always positive outcomes of this process, the creation of small enterprises out of large units can be seen as a necessary step to allow the profitable parts of an enterprise to survive and to permit firms to concentrate on their core business without being burdened by too many side activities. Evidence from the Czech Republic indicates that the firms created out of large establishments do not generally outperform their parent state enterprises, but nevertheless the performance of the latter is improved by this process (EBRD, 1998a: 142).

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<sup>34</sup> These privileges conceded apply only to the proportion of taxes going into the local

The "Concept" foresees also the possibility of setting up innovation centres in the non-utilised premises, following the example of the large instrument-making manufacturer Svetlana. Various kinds of tax advantages and other concessions will also be given to the small enterprises spun off from these units (Pinchuk, 1999: 9; Donskaia, 1998: 5). According to the administration, one of the main objectives of these restructuring plans is a reduction in company overheads, which greatly contribute to the difficult financial situation of many firms. A company's capacity, property and buildings have to be rationalised according to the level of demand for its products. In order to favour this rationalisation, according to a draft law, any profits from the sale of non-utilised equipment will not be liable for taxation. Nowadays in St. Petersburg only 30% of industrial capacity is utilised in the production cycle (interview with Klebanov, Sliusarenko, 1998: 14), but capital assets are taxed even if they are not used in the production process. Otherwise, if a buyer is not found, it is possible to remove from taxable assets the non-utilised industrial capacity for a duration of three years, following the approval of a law in 1998. The premises will be sealed and energy supply interrupted. In this period the city and the enterprise will look for investment to restart production (Zatsepin, 1998a: 4). According to the "Concept", social assets are also to be given away. For example, in 1998 the industrial enterprise Igorskie Zavodi set up five independent firms, transferring to them its social assets, and also transferred eleven hostels to the city (Trexobizkaia, 1998b: 9). The government will control the fulfilment of the conditions agreed which must include the regular payment of a "decent" wage to employees, the possibility for the displaced workers to find employment in the new spin-off firms or in other places and the conservation of the scientific and technological potential<sup>35</sup> of the enterprise (Nevskoe Vremia, 1998, no. 232 and 1999, no. 60: 1). By early 1999, thirty-five firms had expressed an interest in this programme, which has also been endorsed by the Union of Industrialists and

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budget.

<sup>35</sup> How it is ascertained whether an enterprise has maintained its scientific potential following the restructuring is not clear.

Businessmen, but the Committee for Economy and Industrial Policy estimates the total number of enterprises in need of restructuring at about 180-200, especially defence enterprises (Ostiakova and Orlov, 1999). Among the participating firms are some of the biggest enterprises of the city belonging to the machine-building, light industrial and defence sectors. However, progress in this programme has been slow. The paperwork needed to be completed before being entitled to participate in the programme is very cumbersome, and enterprises are strongly advised to avail themselves of the assistance of one of the consulting firms suggested by the Committee for Economy and Industrial Policy, which entails additional expenditure. This might explain why just seventeen firms had submitted their business plans to the city authorities for approval by December 1999. The plans were intended to be discussed by mid-December 1999. At the beginning of that month the first firm - a plywood factory - received financial aid in the framework of this programme (Shcherbakova, 1999c: 11). The amount is, however, not very significant (\$60,000 of tax exemptions in the course of three years), considering that the business plan foresees the expenditure of \$7 million for the plant's restructuring.

Regarding municipal enterprises, restructuring plans are to be devised by a council for restructuring which has been in operation since 1998 as part of the Committee for Economy and Industrial Policy (Bogorad, 1998b: 9). At the instigation of Klebanov a special council for the restructuring of defence enterprises is also to be established in the administration of St. Petersburg, as the local government has succeeded in obtaining from the federal government the power to manage enterprises which have remained federal property<sup>36</sup> in order to carry out its restructuring plans (Pinchuk, 1998: 7; Rybakov, 1999: 8). Klebanov's strategy is to spin off from defence enterprises the parts which are not utilised for military production and to group them together with the military section under one holding company.

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<sup>36</sup> The presence of the state in defence enterprises is still strong. In 1996 37% of the total output of the defence industries in Russia was accounted for by state firms (Kezling, 1997: 6). As a comparison, in St. Petersburg the share of state firms in the total industrial output was 11% in the same year.

Debts and credits with the state arising from the fulfilment of state orders are attributed to the military section, while the remaining debt of the firm is rescheduled so that new enterprises are not burdened with excessive debt (interview with Klebanov, Malinin, 1998a: 8).

Another measure envisaged by Klebanov is the more widespread utilisation of bankruptcy procedures, the aim of which must be to liquidate unprofitable parts of an enterprise and render support to the parts which can be saved, thus avoiding its complete closure. According to Russian law, a firm declared bankrupt by the arbitration court can be either reorganised or put into liquidation. Under the reorganisation alternative, the management is replaced, tax debts are frozen and social assets are transferred to the local government. If the situation does not improve the firm is finally liquidated after eighteen months, although the arbitration court can extend this period. At the end of 1993 a non-judicial procedure was also created to deal with insolvency in state-owned enterprises and joint-stock companies in which the state owns at least 25% of the shares. A Federal Bankruptcy Agency was set up with the power either to liquidate the company or to continue the activity for a given period. However, bankruptcy has involved only a limited number of enterprises (Russian Economic Trends, 1998, no. 1: 93). Firms have little incentive to initiate bankruptcy procedures, because the low priority accorded to private sector claims makes it unlikely that any assets remain after satisfying privileged creditors, and because court decisions are often not implemented. The state and the regions have also been very reluctant to start bankruptcy procedures against enterprises which have defaulted on their tax obligations, intervening only when the situation has left no more hope of saving the enterprise concerned. On the other hand, payment arrears being so widespread, the strict application of bankruptcy procedures would cause a mass closure. A new bankruptcy law, effective since 1 March 1998, was approved to increase the application of bankruptcy procedures, and has resulted in a tripling of the number of bankruptcy suits. Even so, the proportion of firms placed in bankruptcy has remained much lower than in Hungary and the Czech Republic (Russian Economic Trends,

1999, no.1: 81), since the new law has not modified substantially the order in which creditors<sup>37</sup> are to be paid.

#### 4.6. CONCLUSION

In St. Petersburg the fall in industrial output was greater than in Russia as a whole because its industrial structure was largely made up of sectors which have suffered the most in the transition to the market. The chaotic state policy towards defence enterprises has severely obstructed the conversion to civilian production. The financial stabilisation of the city has made huge steps forward since the appointment of Artem'ev as head of the Committee for Finance. He set up a treasury system reducing the influence of commercial banks, two deficit-free budgets were passed, and the municipal debt was restructured. His resignation casts doubt on the continuance of this policy. The legacies of the planned economy have left a strong imprint on the strategies used in the economic policy of the post-Soviet period at both federal and local levels. A Strategic Plan has been devised to set the long-term strategy for the city economy. However, the plan seems sometimes to comprise the sum of the recommendations of all the partners involved without stating clearly how some of the objectives will be achieved, bearing close resemblance in some respects to an old five-year plan. Industrial policy in St. Petersburg has been shaped by a central economy mentality. The free market culture has not yet fully taken root. The administration of St. Petersburg has maintained a strong role in the economy, even after the dismantling of the planned system, partly because the large enterprises, in particular, continually clamour for support which could allow them to overcome the crisis. Lobbying for preferential terms is still very common. An industrial policy is often criticised on the ground that officials are viewed as easy prey to corruption and lacking the competence to administer it, but on the other hand the poor financial state in which enterprises find themselves puts pressure on local governments to aid home-grown industry.

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<sup>37</sup> According to the new law the order is: 1) court costs and payment of costs incurred since the start of bankruptcy proceedings 2) personal injury claims 3) wages 4) collateralised claims 5) debts to budget and extra-budgetary funds 6) uncollateralised claims.

In Russia industry has been penalised by the tax system as well as by the high prices of utilities, which make business hardly profitable. Thus the requests for concessions may be seen as a method to establish fairer rules of the game. Managers too, having worked under a different system, often lack the competence or are overwhelmed by financial hurdles. For this reason, the administration has, not unreasonably, co-opted prominent managers as successive heads of the Committee for Economy and Industrial Policy to use their supposed expertise in solving the problems of local industry. Having said this, it is difficult to judge how effective the policy has been so far. Bodies of the city administration keep formulating plans either for the whole economy or for a selected sector, many of which have remained largely unrealised, as they often seem to have little basis in the local reality. These plans seem to be just an expression of interest. It is not clear under which criteria loans to local industries were granted. In the absence of detailed data on the distribution of subsidies, a clear picture of the industrial policy carried out by the city is hard to obtain. However, following the appointment of Klebanov, St. Petersburg is taking a more practical approach. The concession of subsidies is linked to the fulfilment of the concrete plans for the restructuring of individual enterprises, but this programme is progressing slowly due to the cumbersome procedure needed to qualify for these subsidies.

The administration has also retained a significant role in promoting co-operation with other members of the Federation, signing agreements to exchange locally-made products for the produce of other regions, as in Soviet times. The administration has been particularly active in assuring to the city an adequate supply of food products. The reason for the involvement of local bodies in intra-Russian trade may be linked with the difficulties of doing business with other regions in the absence of clear property rights within Russia. Entrepreneurs complain of being defenceless in cases where the counterpart does not fulfil the term of the contract.

Following the overview of the local economic policies, the next chapter will focus on the small business policy that the local administration carried out

and compare it with that carried out in Moscow in order to detect the main factors which explain the large growth of small business in the two cities.

## **5. SMALL BUSINESS PROMOTION IN ST. PETERSBURG AND MOSCOW**

### **INTRODUCTION**

This chapter will outline the measures taken by local administrations in St. Petersburg and Moscow towards small business and the business community's attitudes towards their policies. A review of the federal policy towards small business is not sufficient, because the economic policy of local administrations has a strong influence on small businesses: a substantial share of the taxation burden is determined by local bodies, as well as the rent of premises, the majority of which are owned by local governments. They also have considerable autonomy in implementing laws and regulations. As emphasised previously, the attitude towards small business has varied greatly in Russia from local administration to local administration. Some regions have not even implemented mandatory federal legislation on small business let alone offered any measure of support, while others have taken matters into their own hands and devised their own policy to promote it. This chapter will consider how St. Petersburg has acted in this context. The experience of St. Petersburg is then compared with Moscow to understand why Moscow is leading in terms of small business development.

#### **5.1. SMALL BUSINESS PROMOTION IN ST. PETERSBURG**

Small business development has been of secondary importance compared with other policy areas under the two administrations St. Petersburg has had in the post-communist period. Little was done before 1996, when two laws on small business and the first city programme of small business support were approved. In the same year the government of St. Petersburg also created the Small Business Council (mayoral resolution of 7 May 1996) composed of specialists in this area with the aim of advising the city administration on small business development and acting as a liaison

between small enterprises and authorities. This Council, which is located in the headquarters of the government of St. Petersburg, is made up of several sub-committees, each engaged in different areas: a sub-committee which represents the administrations of the various city zones, one which deals with foreign economic relations, one with financial policy, one with legislative matters and one with leasing activities. The sub-committee on foreign economic relations is charged with favouring the implementation of international programmes and attracting funds to the city. The sub-committee on legislative matters was the author of the new law on the revised simplified system of taxation and accounting and has drafted a law on leasing to small businesses, while the sub-committee for leasing activities is entrusted with promoting the concession of leasing to small businesses and setting up a leasing company dedicated to small business (Ponomareva, 1997: 18). As of 1998, there were about ten leasing companies in St. Petersburg, three or four of which work with small enterprises, but the standard interest rate of 30% per year on dollar-denominated leases rules out this option for all but a few. For this reason, the demand for leasing has not been very high. Enterprises which have resorted to leasing are mainly firms working in the food and transport service sectors, which are doing well.

The first of the two laws on small business adopted in 1996 was the federal law "On the Simplified System of Taxation and Accounting", which requires that analogous laws be enacted by local authorities in order to be effective at local level. Individuals and legal entities which opt for this system (to be eligible they cannot have more than fifteen employees) have to pay an unique tax equivalent to 10% of gross revenues plus the patent, the cost of which depends on the sector of activity. For wholesalers and retailers gross revenues are defined as the total mark-up on goods sold. The law, however, did not prove very popular. Only 193 small businesses and thirty-two private entrepreneurs out of 39,000 firms and 30,000 individuals eligible for the simplified system (Borisova, 1997b) purchased patents in 1996, since they are generally considered to be too expensive. A patent in

St. Petersburg cost up to April 1998 between \$2,100 and \$8,500, depending on the sector of activity. The number of participating firms increased only slightly by the end of 1997 to 280 (Petrova, 1998: 1). For this reason amendments to the law were approved in April 1998. The tax rate was reduced from 10% to 6.66% and patents were made free of charge for companies, while for individual entrepreneurs the cost was reduced by a third. The simplified system has become especially advantageous following the introduction of the sales tax (5% of the revenues) and the imputed income tax in 1999 because those opting for this system are exempted from them. These new taxes have been introduced to compensate the losses in regional budget revenues deriving from the new revenue sharing criteria set by the federal government<sup>1</sup>. This has led to a sharp rise in the number of firms opting for this system which reached 12,500 by April 1999 (Predprinimatel' Peterburga, 1999, no.15: 4). However, this law is unlikely to prove very popular as long as its main shortcomings (the low limit on the number of employees; the impossibility of establishing the amount of VAT in the total cost of goods bought from enterprises opting for the simplified system; and the lack of a mechanism to allow firms to return to the normal system of accounting) are not corrected by federal legislation. Another problem is that about half of the entrepreneurs in St. Petersburg do not know of its existence (Nepomiashchaia, 1997a: 2).

The second law on small business approved in 1996 was the law no. 137-48 "On Measures of State Support for Small Entrepreneurship in St. Petersburg" endorsed by the legislative assembly of the city on 6 November 1996. It states that *up to 1%* of the city budget must be earmarked every year for the support and development of small business; in other words not providing any absolute minimum to be allocated each year. This law also states that from 1998 (subsequently postponed to 1999) the share of the profits tax and the property tax going to the local budget is lowered by 50%

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<sup>1</sup> In 1999 the share of the income tax, of the VAT and of the profits tax going into local budgets was lowered.

in the first two years of activity for small firms in the industrial sector, on the condition that this activity represents at least 70% of their total turnover.

The first programme for the support and development of small business was approved by the city authorities in 1996 for the years 1995-1996<sup>2</sup> with a budget of 11.5 million roubles (\$2.3 million<sup>3</sup>) (Chas Pik, 1997: 2). Such programmes are worked out by the Committee for Economy and Industrial Policy which is responsible for devising the city policy on small business. The North-Western Regional Fund for Small Business Support (hereafter the North-Western Fund) was entrusted by the Committee for Economy and Industrial Policy with the execution of the programme. Following the foundation of the State Fund for the Development of Small Business in St. Petersburg (hereafter the S.F.S.P.) in June 1996 this responsibility was transferred to this fund. The reason for the existence of two state organisations for the development of small business, both of which strive to be the effective contractors of the small business programme, is that one is favoured by the city Committee for Economy and Industrial Policy (the North-Western Fund) and is actually located in the offices of the local administration, while the other (the S.F.S.P.) is favoured by the legislative assembly. About 60% of the resources of this programme were meant to be used to provide preferential loans not only to finance enterprises, but also projects which should promote the development of the small business sector in St. Petersburg, such as the creation of an information centre and a centre of legal aid for entrepreneurs. (Kiselev, 1996: 20). In theory, half of the resources should have been provided by the city and the federal budget on an equal basis, while the rest was expected to come from the Fund of Employment and from bank loans. In practice, the only financing came from the city and it amounted to 4.5 million roubles (\$900,000) instead of the 11.5 million budgeted (City of St. Petersburg 1996, 1997: 20) and this amount was made up entirely of promissory notes (Shabalina, 1998: 4). As this expenditure was not considered to be a priority it was included in the

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<sup>2</sup> The realisation of the programme was due to begin in 1995, but it was approved by the city government only in 1996.

<sup>3</sup> Calculated at the 1996 exchange rate.

budget cuts to keep the deficit in check. No federal financing was given due to the fact that financing from St. Petersburg for 1996 was disbursed in 1997 at a time when the change of the director of the Federal Fund for Small Business Support effectively immobilised its activity. Similarly, no financing was obtained from other sources.

The city financing of 4.5 million roubles disbursed in 1997 was given to the S.F.S.P. on a grant basis, while the North-Western Fund received a loan of a similar amount. In order to increase the amount of financing available, the S.F.S.P. planned to utilise future financing to set up a guarantee fund instead of directly financing projects. An agreement was reached with various banks that for every rouble of guarantee the banks would give loans for four roubles, but it was never implemented as the S.F.S.P. practically ceased to be operational in 1999 due to financial difficulties (Shabalina, 1998: 4). Even before that the activity of the S.F.S.P. had been strongly criticised by the deputy director of the Committee for Economy and Industrial Policy. The Fund was accused of not having a clear conception of its aims despite having being operational for a few years and of having spent more for its support than for the intended purposes (*Predprinimatel' Peterburga*, 1999, no.13: 3). The S.F.S.P. should in theory carry out a wide range of activity aimed at promoting small business in the city (see pages 227-228), but its activity has been limited to taking part in various exhibitions, enabling several small enterprises to display their products at a very low cost, organising a number of training courses and conceding a few loans (Lazarev, 1998: 14). Less than a third of the financial resources received by the Fund were spent for the intended aims. It financed just five projects in 1998. Moreover, loans to small firms were conceded without a proper evaluation of the business plans submitted and a proper control of how the firm used the financing. As a result, they were largely not returned<sup>4</sup> (Shabalina, 1999: 5; Likhotkin, 1999: 17). Because of all this, the revenues from its activity amounted to only 12% of its expenditures making the Fund almost completely dependent on state financing. Contrary to expectations, it

was also unable to attract any external financing. Cumulative losses amounted by mid-1999 to half of its assets. Despite its financial dependence the S.F.S.P. repeatedly tried to hinder any control over its activity, and its head refused to step down despite being dismissed by the Committee for Economy and Industrial Policy. The impasse terminated when the S.F.S.P. ran out of financial resources and effectively closed down.

Objections have also been raised to the activities of the North-Western Fund, which has not publicised how it utilised the resources allocated to it by the city, even refusing to clarify this issue to a business magazine in St. Petersburg, thereby infringing the law “On the Means of Mass Information” (Kiselev, 1997c: 11). Most were probably spent in salaries and travelling expenses (interview with Yeliseeva). Therefore, it can be said that, as at federal level, the small business support funds in St. Petersburg have proved unable to fulfil the assigned tasks and have been found guilty of gross mismanagement. In order to avoid future cases of malpractice, the Committee for Economy and Industrial Policy is striving to set clear rules which each organisation receiving money from city coffers has to respect. The number of centres promoting small business will probably be reduced in order to exercise better control over their activities and to avoid having organisations with overlapping functions. In addition to these two funds in the city there are a large number of centres involved in small business promotion, but some are almost inactive due to the lack of financial resources. By early 1999 in the city there were about seventy centres claiming to support or represent small business, but only thirty were really operational and the great majority rely for their survival on the support of the local administration. The others only exploit the claim to a promotional role in order to receive rent advantages or are wholly non-operational (Delovaia Panorama, 1999: 8; Delovoi Peterburg, 1998: 5). Despite the existence of so many organisations the number of entrepreneurs who are members of one of these is very limited. According to research carried out

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<sup>4</sup> This would confirm what said by the entrepreneurs that loans were mostly conceded in a non-transparent way.

by the Leontief Center, 94% of them are not members of any association (Leontief Center, 1999: 13).

The Committee for Economy and Industrial Policy itself has been accused by the Small Business Council (Delovoi Peterburg, 1997b: 2) of setting up funds in order to attract resources for the support of such structures, rather than with the aim of providing assistance to the categories these funds are supposed to help. The creation of funds for support of small business, agriculture, industry, etc. has been a favoured activity of the various bodies of the city administration, but the results are hardly visible. As a rule, these funds spell out a wide range of initiatives, plans and programmes which mainly remain unrealised.

The most active organisations on behalf of small business in the past few years have been business support centres and funds established by international donors. They have been the only realistic source of financing for small businesses and have also provided international experts for a considerable number of assignments. They offer in-house consultations on a short-term basis, business advice, loans, and equity finance to small firms. These organisations include the Citizens Democracy Corps (CDC), the Center for Citizen Initiatives, International Executive Service Corps, the Business Collaboration Center<sup>5</sup> and The U.S. Russia Investment Fund (TUSRIF), all financed by USAID; the Small Enterprise Equity Fund (SEEF) and the Russia Small Business Fund, both set up by the EBRD; the Russian Technology Fund, founded by the EBRD in partnership with other foreign and Russian organisations; the St. Petersburg Foundation for SME Development financed by TACIS; the British Executive Service Overseas, financed by the British government; and many others. Consulting organisations offer their services for free or at very low rates, but in the near future they will have to be self-financing, as the financial support from USAID and other bodies is decreasing or even stopped. For this reason their survival is in doubt. Among the programmes whose survival is in doubt is

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<sup>5</sup> This center has been closed down.

the credit programme of the Russian Initiative of Self Employment (RISE) - managed by the Center for Citizen Initiatives - which is based on the experience of the Grameen Bank in Bangladesh. RISE gives micro loans both to entrepreneurs starting up, upon completion of a free-of-charge training programme, and to existing businesses with no more than ten employees. By statute, over 60% of participants must be female. Non-performing loans have been relatively few (four out of sixty), but profits from the micro loan activity do not cover the expenses incurred. The main problem, according to the loan co-ordinator of RISE, is the difficulty in finding suitable projects. Because of this, just sixty projects were financed in 1997-1998, when in order to break-even it would have been necessary to finance fifty projects in a single year. More successful was another RISE initiative, "the Apparel Innovation Center", which is in fact a business incubator geared to the production of clothing and accessories. In the middle of 1996 a total of eighty-eight people were working in the centre, which was fully occupied and managed to become self-sustained. As far as the other American organisation - the CDC - is concerned, its assistance to small businesses in Western Russia was described as very valuable in an assessment carried out by a consulting organisation on behalf of USAID, and the programme providing volunteer consultants as a moderate cost, high impact programme (Carana Corporation, 2000: II).

Unlike the above organisations, the funds have always worked on a self-financing basis, with strict eligibility criteria for the concession of loans. Grants, if given, were received by these funds only at the beginning of their activity. The problem is that the interest rates required by these funds are very high<sup>6</sup> and for this reason are not affordable by the majority of firms. The high costs can be explained by the expenditures incurred not only in the eligibility determination process, but also in following the firms' activities after the concession of loans. Funds officials, usually, visit the client monthly in order to assess the situation, a duty which is not always easy, given the clients' fears that some information might end up in the tax office.

In 1997 about ten million roubles (\$1.7 million) were allocated in the St. Petersburg budget for the development of small business, but this sum was not disbursed, as it was again cancelled due to budget cuts. The programme for small business support in 1998-2000 has been given the status of a law for the first time, requiring approval by the legislative assembly. The amount of resources planned to be set aside is unprecedented. In the draft law submitted to the legislative assembly, financing amounts to 5.12 million roubles (\$510,000) in 1998, 76.87 million in 1999 and 79.53 in 2000 (Predprinimatel' Peterburga, 1998, no.15: 6) and an equal amount should by law come from the Federal Fund for Small Business Support. Almost half of the resources are to be given on a loan basis with strict controls over their use (Predprinimatel' Peterburga, 1998, no.16/17: 4). However, this programme was approved only in May 2000 on the day of the inauguration of the second term of the mayor of St. Petersburg, but financing was cut to twenty-seven million roubles for the year 2000. The reasons for the long delay in the approval of this programme are linked to the struggle in the legislative assembly between the pro- and anti-mayor factions. The main criticism of the law, in addition to the lack of trust in the city bureaucrats to implement this programme effectively, is the fact that the programme is considered to be of secondary importance compared with other issues such as the excessive tax burden and the high rents for the city premises (Predprinimatel' Peterburga, 1999, no.9: 2).

In the plans of the city administration this programme should lead in three years to an increase in the number of workers in small businesses of 60-80,000, a 4% increase in the share of industrial output represented by small firms, and a growth of the analogous share regarding scientific activity of 6% (Eskin, 1998a: 143). The share of small business in the city's GDP should reach 25% and in the total tax revenues of the city 20%. How these figures were calculated has not been publicised. They probably just represent the expectations of the city administration. The programme is

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<sup>6</sup> For example, the interest rates applied by Petrovskii Bank are 16% for 3-year small loans

aimed mainly at firms working in the industrial sector, and in R&D. It has four main directions:

- development of support infrastructure
- investment support through the concession of guarantees, the creation of specific funds and the development of a system of leasing equipment.
- information support.
- improvement of the legislative environment

The main measures envisaged in the programme are the realisation of a programme for the development of innovation activity based on the creation of a network of innovation centres, science parks and business incubators (68% of the total financing); the provision of investments and loans for small firms - especially spin-offs from large enterprises - (12% of the total); the establishment of consulting agencies in different areas of the city and the creation of an information centre where, for example, entrepreneurs can be informed about market trends (9%); and the improvement of the legislative framework for small business (2%)<sup>7</sup>. Regarding the last point the creation of a mechanism to let city property to small businesses on favourable conditions and the allotment of a given share of city procurements to small businesses are envisaged. A few consulting agencies, called Business Development Centres, have already been set up as part of the state programme for small business support. These are non-profit-making organisations which offer consulting at reasonable prices, but have to be self-financing in order to survive, as support from the local administration has come mainly in words rather than actions (Iundina, 1997: 1). One of the most successful was the Business Development Centre of Vasilieski Island which in 1997 had more than 1,500 regular clients on its books (Kiselev, 1997b: 22). This centre had, however, to close down in mid-2000 when the new head of the district where it is located cancelled the rent agreement the centre had signed with his predecessor.

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of up to \$125,000 and 20-21% for 1-year micro loans of up \$30,000.

<sup>7</sup> There is clearly a mistake in these percentages, reported by C. Eskin the deputy director of the Committee for Economy and Industrial Policy of the St. Petersburg administration, as they do not add up to 100 (Delovaia Panorama, 1999: 8).

The measures contained in the programme for small business support have found a moderately positive response among entrepreneurial associations, which, however, complain that they have not been consulted in spite of the promise to discuss the programme with them. In particular, in the opinion of Pastukhov, the President of the Union of Entrepreneurs of St. Petersburg, the programme does not tackle some of the major problems affecting small businesses such as the difficulty of repaying loans in hard currency after the threefold devaluation of the rouble (Ipatova, 1998a: 14).

Some of the measures indicated in the 1998-2000 programme had, however, already been included in the previous programmes, but have remained unfulfilled. For years local authorities have planned to allot industrial and office premises to new entrepreneurs and to give them the opportunity to rent and buy these premises at advantageous prices, but nothing has been done (Nikiforov, 1996a: 4). Considering that most of the premises are in state hands it is clear that local authorities have a very powerful tool to promote entrepreneurship. The unavailability of premises is in many regions one of the major obstacles to the development of small businesses, the other problem being that entrepreneurs are often uncertain as to how long they can remain in rented premises. Legally it would be possible to extend the lease to up to forty years, but local authorities have generally been unwilling to make rental agreements for more than five or six years and have also proved ready to cancel the agreements, if a third party offers better conditions, even if this entails breaking the law.

The concession of guarantees and the promotion of leasing had also been proposed, but not implemented for several years. A guarantee fund for the concession of loans to small enterprises was called for by the mayor in mid-1997. He signed the resolution "On a Guarantee Fund of Support for Small Business in St. Petersburg". This resolution was in reality a recommendation to the Committee for Finance to concede to the North-Western Fund a five million roubles loan (\$860,000) designed to form a

guarantee fund (Peterburgskii Kommercheskii Kur'er, 1997, no. 13, 2), but no financing has been yet provided for this guarantee fund as well as for the city leasing company for small business created in September 1997.

Has the rather limited activity pursued by the city administration had any positive effect? The activity of the Small Business Council has hardly been noticed. As declared by Khod'ko (Peterburgskii Kommercheskii Kur'er, 1997, n.7: 1), the chairman of the sub-committee on foreign economic relations, its contribution has been minimal. Apart from elaborating a revised simplified system of taxation and accounting which became law, its activity has resulted in a few proposals<sup>8</sup> which have remained unheeded. Legislation is usually approved by the governor without the active involvement of the Council (Pastukhov, 1998: 23). Because of this the Council has practically stopped being operational (Gavrilov, 2000: 2). The two funds have both mismanaged the resources assigned and have provided only a token assistance to small business. Similarly, the measures proposed by the city administration have largely remained unimplemented. A further indication of the erratic city policy towards small business is the fate of the Business Development Centre of Vasilieski Island. Therefore, it can be said the development of the small business sector has taken place despite lack of interest by the local administration.

The economic policy pursued in St. Petersburg towards the small business sector has been strongly criticised both by the entrepreneurial class and by the political parties which are closer to it. According to a local representative of the national party Yabloko the policy pursued had by mid-1997 brought a strengthening of the process of monopolisation (Korotkova, 1997b: 6). In his opinion, high registration fees, tax burdens and the rent increase for commercial premises have stifled the creation of new enterprises and made the survival of the existing ones difficult. In addition,

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<sup>8</sup> The council has proposed the creation of a marketing research centre, the creation of a guarantee fund for small enterprises managed by the North-Western Fund, a congress to celebrate the ten years since small enterprises were allowed in Russia, the promotion of leasing and franchising and the realisation of a city programme to foster entrepreneurship among young people in 1997-1998 (Predprinimatel' Peterburga, 1997, n. 22: 4-5).

he remarked that the introduction of the new procedure for setting the rent of commercial premises does not protect entrepreneurs from abuses by city officials. The method only fixes standard rents, and the use of a higher or lower coefficient (in relation to the location and type of the building) depends on the decision of the official in the district's City Property Committee. Well-connected entrepreneurs are said to have been able to obtain much better conditions. Some of them have obtained premises at a nominal cost, tax deferments, city orders or exemptions from inspection. Cases of abuse of power and other anti-competitive practices should, in theory, be sanctioned by the State Anti-Monopoly Committee for the Development of Entrepreneurship, which is entrusted with investigating these matters, but it has so far not proved very effective. In an overview of the St. Petersburg Anti-Monopoly Committee, Sahlas and Reshetnikova (1997: 66) described it as "to date unable to fulfil completely its assigned tasks".

The entrepreneurial class has been equally critical of the administration. The resolution of the second congress of the entrepreneurs of St. Petersburg in November 1997 affirmed (Predprinimatel' Peterburga, 1997, no.23: 5) that: "The level of small business development (in St. Petersburg) occupies one of the last places in Russia. This is to a considerable extent the result of the attitude of the administration and of the legislative assembly towards the problems of entrepreneurship. In St. Petersburg there is no legal stability, legal documents are approved without the necessary legal expertise and without evaluating the social and economic consequences of their realisation; a unique legal space does not exist as territorial bodies of the administration introduce their rules and additional charges. The malpractice of the departments in charge of registrations, supply of information, licences, supervision and control over small business is continuing. There are no normative documents establishing the order and the deadline for taking decisions, the responsibility of the departments and officials infringing the rights of entrepreneurs and causing to them material and moral losses."

One of the problems is the lack of a mechanism to enforce local laws on small business. The majority of taxes and other regulations affecting small business are open to the subjective interpretation of government officials. For example, territorial branches of the tax authority continued to ask for the payment of the patent to companies opting for the simplified system of taxation and accounting, even after the approval of the law which made patents free of charge (Predprinimatel' Peterburga, 1998, no.12: 3).

In reality, the data give a different picture, as already explained in chapter three. Small business in St. Petersburg is expanding very quickly by Russian standards, even if its level still trails behind Moscow and the leading transition countries. The criticism at the congress was aimed at the lack of interest shown by the local administration in improving business conditions and in reining in the frequent abuse of power by bureaucrats who see small businesses mainly as a source of personal revenue. According to the participants of the congress, in the administration of St. Petersburg, a structure sufficiently competent to cope with the problems of small business does not exist.

Similarly, the President of the Union of Entrepreneurs of St. Petersburg, R. Pastukhov, declared that not even one of the problems indicated in the first congress of the Union held in 1997 has been tackled by the city administration and that the situation for small and medium firms has worsened ever since. He complained that neither the city legislative assembly nor the city administration are attentive to the problems affecting small businesses (Kirillova, 1999: 3).

In spite of the existence of numerous associations of entrepreneurs, their interests have scarce political representation at the regional level. The association representing the greatest number of entrepreneurs (1,500 in 1998) in St. Petersburg is the Union of Entrepreneurs, which accepts only small and medium-sized businesses. The Chamber of Commerce comes a

distant second with 850 associates of any size (as declared in their brochure). Associations assume an important role in the transition process, serving as a source of information for private firms (on legislation, business partners, etc.) and practical help for the creation and management of a business, but in Russia entrepreneurs have been reluctant to join organisations claiming to represent them, being generally sceptical of their usefulness.

Only during the last few years can a more focused attention on small business be detected. A positive sign is the creation in 1999 of a single licence chamber in St. Petersburg where entrepreneurs can obtain all the information on this matter without having to refer, as before, to the countless bodies in charge of licensing (Laverycheva, 1999: 5). The mayor, after having ignored the second congress of the entrepreneurs of St. Petersburg, intervened at the third congress in October 1999, pointing to the vast increase in resources earmarked for the small business programme as proof of the dedication of the current administration to the sector. In view of the forthcoming elections, to be held in the year 2000, he can not afford to ignore a sector whose weight in the local economy is growing year after year. However, unless the measures indicated in the programme are effectively implemented the main problems affecting small business in the city will remain untackled.

Having now examined how the local administration has dealt with small business, the following section provides an overview of how Moscow has fared in this respect and how the capital differs from St. Petersburg, in order to explain the greater development of the sector in Moscow.

## **5.2. SMALL BUSINESS PROMOTION IN MOSCOW**

Moscow is the leading city in Russia in terms of small business development. Thirty-nine per cent of the workforce was employed by small

businesses in 1997<sup>9</sup> (Goskomstat, 1998d: 174-350). Half of the revenues of the city budget are derived from small enterprises. In the last few years, as declared by Luzkov the mayor of Moscow: “1,200,000 Muscovites have been released by big enterprises and, considering the fact that the unemployment rate in Moscow is zero<sup>10</sup>, all of them must have found employment in small businesses” (Predprinimatel’ Peterburga, 1998, no.1/2: 6).

This phenomenon can be attributed to two factors: the far greater wealth of Moscow, and the active policy of the Moscow government in promoting entrepreneurship. Moscow enjoyed a higher standard of living compared with the rest of the Soviet Union even in the communist period. It was favoured in the distribution of goods. The gap in living standards between Moscow and the rest of Russia has become still more pronounced in the post-communist period. A study undertaken between 1992 and 1995 by the Expert Institute showed that Moscow was the region with the highest income levels and highest rates of income growth (Voprosy Ekonomiki, 1996: 44) and this process is still continuing: in 1995 real monetary incomes in Moscow were 3.5 times higher than in the country as a whole, while in 1997 they had become 3.8 times higher (Goskomstat, 1998d: 210). A concrete example of the gap in living standards between Moscow and the other parts of the Russian Federation is indicated by the fact that in 1996 Moscow provided 31% of the revenues in the federal budget (Predprinimatel’ Peterburga, 1998, no.1/2: 6), with only one-fourteenth of the Russian population.

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<sup>9</sup> This includes full-time permanent workers and contract workers, but excludes part-time workers.

<sup>10</sup> Official statistics on unemployment in Russia include only those who are registered in the unemployment offices. Low unemployment benefits mean that a large number of unemployed persons do not register themselves. The official unemployment rate in Moscow was 1% at the end of 1996, much lower than the rate for Russia as a whole. Instead, according to the ILO concept it was 5% in March 1996 which is considered to be a level of full employment (OECD, 1997: 40). In Russia as a whole the unemployment rate according to the ILO concept was 9.6% in 1996 (Russian Economic Trends, 1999, no.1, 104).

Concerning small business support, the legal base for the support of entrepreneurship in Moscow was introduced in the years 1993-1995. Moscow was the first region in the Russian Federation to approve a law on small business, and the amounts allocated to its programme for small business support surpass by far those in other regions. The Moscow government has earmarked 971 million roubles (\$98 million<sup>11</sup>) for the years 1998-2000 for the development of small business (Predprinimatel' Peterburga, 1997, no.24: 2). The necessary criteria for the receipt of support from the local administration are listed in the law "The Basis of Small Entrepreneurship on Moscow" (approved in June 1995) which supplements the federal law on state support of entrepreneurship<sup>12</sup>.

According to the local legislation financing for this programme must not be less than 0.5% of the revenues of the city budget and, not less than 5% of revenues from the privatisation of municipal property. The main objectives of the programme for the years 1998-2000 are to promote the leasing of entire production complexes and commercial premises and to expand international contacts and co-operation through specialised exhibitions for small businesses, while the main measures already realised in the framework of the past programmes are:

- the compulsory letting on advantageous terms in all city districts of some of the buildings, equipment, industrial and office premises, and other property belonging to federal and municipal authorities. Open competitions for the purchase of buildings are also regularly organised for small business owners exclusively. For this purpose, by law, territorial bodies of the government of Moscow are obliged to set aside a given portion of state property to be privatised and of buildings

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<sup>11</sup> Calculated at the average exchange rate in 1998.

<sup>12</sup> This law differs from the federal law on these points:

- the ceiling regarding the number of workers is increased to 200 for industrial enterprises and construction firms, to 100 in other sectors of material production and sixty in the service sector.
- small businesses must be included in a special register of small enterprises held by the local administration in Moscow.
- the basic activity must correspond to one of the priority sectors established by the city administration.

confiscated from landlords who acquired them illegally. Research has, in fact, shown that the high costs of renting business premises in Moscow is one of the main factors hindering the development of small business. Fifty per cent of the inactive small enterprises cannot operate because they cannot afford premises, and 50% of those in operation do not have fixed premises (Mali Biznes Moskvi, 1998: 4).

- a business incubator has been set up in almost all city districts. While in 1994 there were only two business incubators in Moscow, neither of which had been founded by the city government, this number has risen to sixteen by the beginning of 1998 (Egorov, 1998: 27).
- the Moscow Leasing Company (MLC) was established in 1993 with the sole aim of leasing different kinds of equipment to small businesses (mainly to firms working in the industrial sectors prioritised by Moscow). Up to 1996 total financing amounted to more than seventy million roubles - \$13.7 million<sup>13</sup> (Iundina, 1998a: 7). The MLC claims a high repayment rate, having had only two cases of non-payment in the first two years of its work (IPSSA, 1997a: 39).

According to a survey carried out in Moscow in 1995-6 (covering 106 small firms) as much as 15% of small businesses had received some sort of aid from the local administration, although in one-third of the cases it was simply a tax concession such as the reduction of profits tax. The most common type of aid was the rent of premises at favourable terms (this applied to 6% of the firms surveyed) which means that about 12,000 firms in Moscow have benefited from this - a remarkable figure (Voprosy Statistiki, 1996, no.11: 44).

To what extent the policies pursued by the Moscow administration have been beneficial to small business is an open question. From research undertaken so far, the role of the Moscow government as a champion of small business does not emerge very clearly. A survey conducted in 1996 pointed out that the conditions for business in Moscow have not improved according to more than half of its entrepreneurs (Business Collaboration

Center, 1998: 1). Only 12% believed that the conditions had improved considerably. Thirty per cent said that the conditions were not very good, but at least there were some positive changes<sup>14</sup>. The Moscow government does not seem to have been capable of reducing bureaucratic complications. Licensing requirements in Moscow were seen to create significant barriers to entrepreneurial activity in the city by the director of the State Anti-Monopoly Committee's Moscow branch (Nelson and Kuzes, 1995b: 113). In mid-1994 the department of the city administration devoted exclusively to licensing entrepreneurial activity had more than 1,000 employees (Nelson and Kuzes, 1995b: 112), and still in 1999 it was necessary to obtain the permissions of dozens of authorities to open a business (Korenevskii, 1999: 2). Even if we concede that the policy has had beneficial results it is only one of several factors which make small business so developed in Moscow and the standard of life there much higher than in the rest of Russia. There are a variety of reasons for this gap in living standards: much of the foreign investment in Russia has gone to Moscow<sup>15</sup>; privatisation has favoured Moscow-based entrepreneurs (especially the members of the oligarchy who once boasted control of half of the Russian economy); all the major banks are based in Moscow; some major companies with factories throughout Russia have their headquarters in Moscow and pay a substantial amount of their taxes to Moscow. The exceptional development of small business in Moscow, by Russian standards, seems to lie, therefore, more in its high level of wealth, rather than in any government policy. This has resulted in a significant development of the service sector which accounts for 85% of Moscow's GDP compared with 65% in St. Petersburg<sup>16</sup> (Hodachek, 1998: 12). Over the period 1992-1994 Moscow has led in new service growth and has greatly surpassed the other regions in this respect

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<sup>13</sup> Calculated at the average exchange rate in 1996.

<sup>14</sup> No date was given for when the comparison was made. Presumably it was made with the previous two-three years.

<sup>15</sup> For example, in the years 1994-1995-1996 the city of Moscow attracted 28.3%, 50.7% and 40.4% of the total foreign direct investment received by Russia (OECD, 1997: 127).

<sup>16</sup> I presume that the author was looking at 1997, having written the article in 1998, although it does not mention any date. In reality, services in St. Petersburg GDP accounted for 60.8% of its GDP in 1997, but Goskomstat also included taxes - 8.8% - in its calculation (Goskomstat, 1998b: 10). As taxes are not usually included in GDP, excluding

(see table 5.1 on page 220). The same pattern was found in 1997 suggesting a continuous trend. By 1997 Moscow accounted for 27% of the country's retail trade with 7% of the population (Russian Economic Trends, January 1998: 5). Small business in manufacturing has, instead, lagged. By 1996, 15% of industrial output in Moscow came from small firms (Finansy, 1997: 38), which is less than the share accounted by small businesses in St. Petersburg. This is a disappointing figure considering that the decrease in production in Moscow exceeded the Russian average between 1992 and 1995 (Voprosy Ekonomiki, 1996: 54; Van Selm, 1998: 610).

### 5.3. CONCLUSION

An enormous task was faced by the city administration after the downfall of the command system. A whole set of new problems had to be tackled and this is likely to have deflected attention away from small business. A clear commitment from the local administration to improve the situation has, however, been absent. It has so far done very little to support this sector, merely approving mandatory federal legislation and the programmes of small business support which have, however, largely remained unimplemented. Like the industrial policy pursued in the city, various committees have been set up to advise the government and a lot of different measures have been proposed, but most have not yet been applied. No concrete effort has been made to ease the main problems affecting small businesses in the city (the high cost of premises, the difficulty of obtaining loans, the high level of taxation, the bureaucratic racketeering, etc.). The only positive steps have been the revision of the law on the simplified system of taxation and accounting and the creation of a single licence chamber. The level of finance allocated to small business programmes was up to 1998 well below the ceiling set by the law (in 1998 it was 0.05% of the budget expenditure<sup>17</sup>), but nevertheless it has, in large part, not been

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taxes the contribution of services would account for about 67%, which is close to Hodachek's figure.

<sup>17</sup> This calculation was based on figures provided by the publication Budget of St. Petersburg for 1998 by the Committee for Finance of the St. Petersburg administration, page 12.

disbursed. Only in the last two years (1998 and 1999) can a greater attention towards small business be detected, probably in view of the forthcoming election. The allocations for small business development have been greatly increased for 1999-2000. These, however, were approved by the legislative assembly only in May 2000 and only for that year and were reduced by about two-thirds.

Despite the non-implementation of the small business programme, the objectives set out in this programme for the years 1998-2000 in terms of small business employment had already been achieved by 1998. Having said this, it is reasonable to ask what may have caused small business to develop so strongly in the city, despite the city having an income which is much lower than Moscow - only slightly higher than the Russian average<sup>18</sup> - and despite the lack of support from the local administration. In Moscow the growth of small business seems to have been largely the result of the high level of wealth, while the positive effects of the government policy are not very clear. One question mark concerns the reliability of these figures as impressionistic evidence would appear to suggest a higher standard of living in St. Petersburg, than that officially stated. Apart from this, the factors which may explain the great expansion of the small business sector in St. Petersburg are mainly:

- The high educational level of the population and their “Western mentality”, which makes them more prone to engage in entrepreneurial activity.
- The presence of a small, but relevant, by Russian standards, middle class. The population is characterised by a high proportion of pensioners with very low incomes, which means that there is a sizeable share of the population with higher than average incomes, who have money to spend on non-essential goods.
- Spending in the city economy is boosted by the presence of a sizeable foreign community - about 12-15,000 people (Economist Intelligence

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<sup>18</sup> In 1997 average incomes in St. Petersburg were 8.3% higher than in Russia as a whole (Goskomstat, 1998d: 210).

Unit, 1999: 15) - and a steady influx of tourists, as well as workers from the surrounding region.

- The proximity to the West has favoured the establishment of foreign chains and the influx of foreign investment, which feel it cannot ignore the second largest city in Russia and has set up its own shops. In the years 1994-95-96 St. Petersburg attracted two or three times more foreign direct investment per capita than the country as a whole (OECD, 1997: 127).

This explains why retail trade per capita was between 26% and 50% higher than in Russia as a whole in the years 1995-1996-1997 (Goskomstat, 1998d: 585), and why small business growth has been mainly concentrated in trade. Data referring to 1992-1994 indicate that St. Petersburg was one of the leading entities in Russia, as far as new service growth was concerned, even though still far behind Moscow in this respect (see table 5.1). Notwithstanding the vitality of the small business sector, the St. Petersburg economy has not performed any better than the country as a whole, due to the poorer performance of the industrial sector (see table 5.2.)<sup>19</sup>.

TABLE 5.1.

Growth in the service sector 1992-1994

Top performers	
Moscow	+54.2%
Adygeya	+23.1%
Perm	+21.6%
St. Petersburg	+19.5%
Sverdlosk	+18.0%
Moscow Oblast	+13.3%
Samara	+13.1%
<b>Average in Russia</b>	<b>+7.4%</b>

Source: Goskomstat data reported by Bradshaw, Stenning and Sutherland, 1998: 153.

TABLE 5.2.

GDP trends

	1995	1996	1997	1998
St. Petersburg	-6%	-10%	-0.30%	-1.80%
Russia	-4.7%	-4.0%	+0.8%	-5%

Sources for St. Petersburg: Goskomstat, 1996g: 1; Goskomstat, 1997e: 4; Goskomstat, 1998b: 3; Goskomstat, 1999: 3

Sources for Russia: Russian Economic Trends, 1999, no. 2: 101 and EBRD, 1998a: 225

The next chapter will examine how entrepreneurs are affected by the business environment in St. Petersburg, giving a first-hand account of small business activity from the interviews I carried out and from questionnaire replies.

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<sup>19</sup> Before 1995 we do not have data on St. Petersburg's GDP, but only on different sectors (industry, retail trade, etc.)

## **APPENDIX: MAIN ORGANISATIONS WORKING WITH SMALL BUSINESSES IN ST. PETERSBURG**

### **RUSSIAN ORGANISATIONS:**

#### **BUSINESS DEVELOPMENT CENTRE**

Address: Pr. Prosveshcheniia 62, 194292, St. Petersburg.

Tel.: (812) 591 3234

Director: Naum Pechatnikov

The centre was created in the framework of the programme “District as an indivisible economic structure”, whose target is to create an infrastructure of support for small business in the city districts. In the district where it is located the centre has nine branches where entrepreneurs can receive a range of services, from assistance in registration to the selection of personnel. The centre has three basic directions:

- the “Visit-club”. Both firms and individual entrepreneurs can become members and receive a range of services at an advantageous price.
- an educational centre where teaching and training in various aspects of entrepreneurial activity takes place. Here there are also seminars in the fields of information technology, management of personnel, advertising, public relations, marketing, management, taxation and preparation of business plans.
- Centre for the Promotion of Entrepreneurship which provides the following services: evaluation of investment projects, legal services, registration of firms and preparation of foundation documents according to legal requirements, account keeping, etc.

#### **COMMITTEE FOR THE EMPLOYMENT OF THE POPULATION**

Address: Proletarskii Diktatory 1, 193060, St. Petersburg.

Tel.: (812) 276-2704 Fax: (812) 276-1003

E-Mail: chair\_work@gov.spb.ru

Webpage: <http://www.smesupport.leontief.ru/framru3.htm>

In mid-1997 the Committee opened a consulting centre where unemployed people willing to set up a firm can obtain free advice. The Committee also assists them with loans, training in the basics of entrepreneurial activity and the preparation of business plans. There is also a specific programme aimed at helping the unemployed create new businesses with unutilised premises and idle equipment. Workers dismissed from enterprises can receive support from this committee to restart unused plants. The Committee claims that there are successful examples of workers who managed not only to re-establish, but also to modernise enterprises, and in time to sell to foreign markets (Gruzinova, 1998: 2). In total, during the five years the programme has been in operation, 24,000 consultations have been provided and assistance has been given in the establishment of 741 enterprises which have led to the creation of 1,400 jobs (Department of the Federal Service for the Employment of the Population of St. Petersburg).

#### NORTH-WESTERN ASSOCIATION OF CREDIT UNIONS

Address: Ul. Smol'nogo 3, room 1-11, 193311, St. Petersburg.

Tel./Fax: (812) 110 0061

Representative: Galina Sedova

Webpage: <http://www.smesupport.leontief.ru/framru3.htm>

This association has nine credit unions as members with a combined membership of 535 people. Six more credit unions with a total of 140 members are in the process of joining the association. The aim is to develop and co-ordinate the activities of the credit unions in the region, to liaise with other similar Russian and foreign associations and to strengthen the economic and social status of the credit unions in order to enable them to obtain more financial resources for distribution. Seminars are regularly organised for its members concerning the various aspects of the activities of credit unions.

## NORTH-WESTERN REGIONAL FUND FOR SMALL BUSINESS SUPPORT

Address: Pr. Voznesenskii 16, room 424, 190000, St. Petersburg.

Tel.: (812) 319 9393.

General director: Vladimir Mikailovich Steniaev

The Fund was set up in 1994. It is a non-profit-making organisation in which the state owns 57% of the capital. It was founded by the Committee for the Employment of the Population, the Anti-Monopoly Committee Committee for the Development of Entrepreneurship, the Social Organisation "Green Cross" and the North-Western Agency for the Support of Entrepreneurship and Investments. The Fund lists among its aims:

- the analysis of business projects and the search for investors.
- the realisation of domestic and international leasing.
- the realisation of initiatives aimed at attracting domestic and international investors, including competitions and exhibitions.
- consulting and market research.
- the realisation of international activity, including participation in international programmes and agreements.
- the realisation of the Federal Programme of Small Business Support.

## STATE FUND FOR THE PROMOTION OF ENTREPRENEURSHIP

Address: Pr. Izmailovskii 14, 198005, St. Petersburg.

Tel.: (812) 112 6604 Fax: (812) 325 5110

General director: Irina Pronina

The State Fund was established by the city administration in June 1996, but ceased to be operational in 1999. Before it was shut down it had, in addition to its main office, two branches in different city districts. The fund was divided into three sections: financial, information and innovation-marketing.

The main declared aim of this organisation was the realisation of an effective system to provide financial resources for small business from different sources. The other aims indicated include the organisation of training courses for entrepreneurs, the promotion of innovation activity, the participation in the creation of consulting and information centres for small businesses, the financing of conferences on scientific research, the provision of consultation on business planning, legal and information services, searching for partners in Russia and abroad, and so on.

#### ST. PETERSBURG CHAMBER OF COMMERCE AND INDUSTRY

Address: Ul. Chaikovskogo 46-48, 191194, St. Petersburg.

Tel.: (812) 273 4896 Fax: (812) 272 6406

Head of the section for the promotion and development of entrepreneurship:  
Liudmila Ivanova.

Webpage: <http://www.spbcc.ru>

The St. Petersburg Chamber of Commerce and Industry is a non-profit-making private organisation. It is the oldest Chamber of Commerce in Russia, having been founded in 1921. It is also one of the largest in the country, though small by international standards, having about 850 members among big and small enterprises in St. Petersburg and the Leningrad region, up from 340 in the 1980s (not really a great achievement considering the large increase in the number of firms in this period). Sixty-one per cent of its members are small firms with up to 100 employees (Shapovalov, 1999: 2). By late 1998 it had established contacts with 300 chambers of commerce worldwide and had signed cooperation agreements with thirty-two of them. Throughout the year seminars and business meetings are organised. Besides this, the main services provided by the chamber are:

- consulting in foreign trade, evaluation of real estate and equipment, assistance in the registration, preparation of business plans, market research and search for partners in Russia and abroad.

- information on exhibitions in Russia and abroad, selection of the most important legal documents, diffusion of information on its members and their commercial offers in Russia and abroad. It has a large reference library freely available for its members. In 1996 a computerised database of business offers and requests of foreign firms was created. By mid-1999 this had about 3,000 offers.
- oral and written translations.
- organisation of training courses mostly of an advanced nature for the employees of the member firms. For this purpose it has created the Foundation for Business and Professional Training.
- the resolution of disputes through the Arbitration Tribunal which has been operative since 1994.

#### ST. PETERSBURG FOUNDATION FOR SME DEVELOPMENT<sup>20</sup>

Address: Pr. Izmailovskii 14, 198052, St. Petersburg.

Tel.: (812) 325 8351, 251 7677 Fax: (812) 112 6607

General director: Sergei Alekseevich Balanov

Webpage: <http://www.fbd.spb.ru>

The St. Petersburg Foundation, one of the first organisations for small business support established in Russia, was set up in the framework of the TACIS programme in 1995 and is one of the most complete business consulting organisations in St. Petersburg, having acquired considerable expertise. It is a non-profit-making organisation which invests all its profits in its development. Since 1996 the Foundation has been included in the registry of consulting firms for the PHARE and TACIS programme, allowing the foundation to submit tenders to the PHARE and TACIS projects. It already takes part in several international programmes to foster international cooperation, such as Europartneriat, Enterprise (Agrinord, Leather), Eurolink, Joint Venture Programme (JVP). More than 200 firms

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<sup>20</sup> This organisation, although set up in the framework of the TACIS programme is currently staffed exclusively by Russians and therefore has been included among the Russian organisations.

from St. Petersburg have taken part to these events. The Foundation is a member of the largest SME support network in Russia, which includes fifty regions and cities, and it is also the representative in Russia of the “Bureau de Rapprochement des Entreprises”. The services provided by the Foundation can be divided into three areas:

- consultation such as assistance in doing business in Russia, legal and customs information and searching for Russian and foreign partners.
- market research.
- training. The range of courses includes introductory courses for new entrepreneurs such as how to register a company in St. Petersburg, courses for recently set up businesses such as business planning and business development strategy, and more advanced courses such as human resource management and international marketing.

#### ST. PETERSBURG UNION OF ENTREPRENEURS

Address: Ulitsa Baltiiskaia 24, 198095, St. Petersburg.

Tel./Fax: (812) 252 1006, 252 0150

President: Roman Pastukhov

The Union was established in late 1997 by fifteen organisations, one of which is the Union of Entrepreneurs of the Kirov district (1,000 members at that time), one of the first associations of its kind in Russia established ten years before (Kiselev, 1997e: 6). Currently it has offices in three districts of the city, but it is planning to open new ones in four more districts. They claim to be the biggest organisation of this kind not only in St. Petersburg, but in the whole of Russia (Solomakhin, 1999: 2). The Union is one of the founders, together with the city administration, of the journal “*Predprinimatel' Peterburga*” (The Entrepreneur of St. Petersburg). The main tasks of the Union are legal defence and lobbying on behalf of its members in state bodies and the provision of free consulting and training. Free consulting is offered daily in the field of taxation, accounting, legal matters, loans issues, securities, insurance and the creation and registration

of the firm. Various courses are organised both for entrepreneurs starting up and for the personnel of small firms. Recently several sections have been created (medical, marketing, retail trade, public catering, transport, construction) to meet better the specific requirements of particular sectors. In addition it has also a section for international contacts.

## **FOREIGN ORGANISATIONS:**

### **BRITISH EXECUTIVE SERVICE OVERSEAS (BESO)**

Tel.: (812) 312 1361 E-mail: [enews@infopro.spb.su](mailto:enews@infopro.spb.su)

Representative: Jean Millington

Webpage: <http://www.beso.org>

BESO, created in 1972 by the Confederation of British Industry and by the Institute of Directors, is a development agency which offers professional expertise to organisations in less developed communities worldwide that cannot afford commercial consultants. It has more than 3,650 experts in its database. In Russia it provides consultants for small and medium Russian firms, especially producers of food and consumer goods. More than 250 placements have been made. The assignment of the consultant lasts from one week to three months. The expenditures of the Russian firms are minimal: only the transport costs to and from the work place, food and accommodation for the consultant, and translation services.

### **CENTER FOR CITIZEN INITIATIVES (CCI)**

Address: Ul. Azrromnaia 4, room 307, 197348, St. Petersburg.

Tel.: (812) 394 7004, 394 0659 Fax: (812) 394 7355

Webpage: <http://www.ccisf.org>

This organisation runs the following programmes in St. Petersburg:

## 1. Russian Initiative For Self-Employment (RISE)

Address: Ul. Drovyanaya 6/8, 198103, St. Petersburg.

RISE has three main programme activities

- **Business Education Programme.** Every month workshops and seminars are organised for would-be entrepreneurs. A training programme lasting seventy hours is offered. The areas covered are marketing, human resources management, financial management and legal issues pertaining to business registration.
- **Credit and Leasing Programme.** The participants in the training course are entitled to apply to a small seed loan or equipment lease. If the business plan is approved they receive a first loan of up to \$5,000 and once this is returned they can receive a larger loan of up to \$20,000.
- **Business Incubator for the Production of Clothes.** After the completion of a training programme participants have access to fully equipped work spaces of varying sizes. State-of-the-art equipment is also available. Tenants can attend seminars led by local and Western experts and read various trade publications kept in the fashion library. Consulting on all major aspects of the clothing business is also available.

## 2. Productivity Enhancement Programme

This is aimed at promoting the production of consumer goods and increasing productivity. It includes an intensive training programme in the United States for 23-28 days.

## CITIZENS DEMOCRACY CORPS (CDC)

Address: Pr. Nevsky 25, St. Petersburg.

Tel.: (812) 346 7706 Tel./Fax: (812) 346 7811

Webpage: <http://www.cdc.org>

This is a private non-profit-making organisation created in 1990 on the initiative of the former U.S. president G. Bush. It administers the Entrepreneurial Business Services (EBS). The EBS focuses its assistance on the development of Russian small and medium-sized businesses by placing

qualified American volunteers. The transfer of skills from American volunteer organisations to their local Russian partners is also envisaged, so the latter can continue to provide American business services even after USAID support is terminated.

#### INTERNATIONAL EXECUTIVE SERVICE CORPS (IESC)

Address: 13-Liniia 14, 193124, St. Petersburg.

Tel.: (812) 118 1946-7-8 Fax: (812) 118 1949

Regional director: David Kerry

Webpage: <http://www.iesc.org>

IESC is a private non-commercial organisation financed by USAID with more than thirty years experience in 120 countries of the world. In its database it has more than 13,000 experts who until recently held high positions in large American companies. In Russia it assists domestic firms by placing experienced consultants with them for an average period of three months. The client firm usually has to pay only for the accommodation of the consultant and for a translator. In Russia by early 1998 it had performed more than 820 assignments.

#### RUSSIA SMALL BUSINESS FUND

Address: Micro and Small Loans Office, Naberezhnaya Kanala Griboedova 25, office 15, 191186, St. Petersburg.

Tel.: (812) 311 6231 Tel./Fax: (812) 314 5558

E-mail: [st-petersburg@rsbf.ru](mailto:st-petersburg@rsbf.ru)

Webpage: <http://www.ebrd.org/english/oper/Country/index.htm>

This fund, launched in 1994, had by the year 2000 made more than 26,000 loans amounting to \$350 million. It provides both micro-loans from \$100 to \$30,000 for a period of one to twenty-four months to enterprises with a maximum of twenty employees and small loans of up to \$125,000 for a

period of one to thirty-six months to firms with up to eighty employees. Concerning the number of employees there is, however, no strict limit. All over Russia the Fund has a ratio of arrears of only 1.8% for micro loans and 2.8% for small loans (arrears are counted from the first day of the delay in paying back). Overall, repayment levels account to 99.8% (EBRD, 1998b: 23). Preference is given to existing and profitable firms. Loans to new firms are quite rare. In this case the condition is that no less than one-third of the total resources necessary for the creation of the firm must come from the firm's own funds. In St. Petersburg the Petrovskii Bank has run this programme since March 1995. Up to 1999 it had given 187 small loans and 1,083 micro loans for a total of \$33 million. It is estimated that 2,500 jobs have been created with the loans conceded (Leontief Center, 1999: 34). In 1999 the KMB Bank, where the EBRD has a majority stake, also joined this programme in St. Petersburg. In that year it gave 1,200 loans for a total of \$18 million.

#### SMALL ENTERPRISE EQUITY FUND (SEEF)

Address: Pr. Lermontovskii 7, 190009, St. Petersburg.

Tel.: (812) 114 2632, 114 3181 Fax: (812) 325 6337

General director: Jonathan Carr

Webpage: <http://www.seafweb.org>

This fund has branches only in St. Petersburg (this also covers the Leningrad region) and Nizhny Novgorod. It provides a combination of debt and equity financing of up to \$500,000 (as a rule buying a minority stake) to small businesses employing up to 150 people in the industrial and service sectors. The businesses must be private and in existence for not less than 2-3 years. Technical assistance is also provided, as the aim of the Fund is to increase the value of the company and to re-sell its stake after a period of three to five years back to a partner (the preferred solution) or on the market. In order to be considered firms must be Russian-owned, have a successful track record and have significant competitive advantage in their industry. The

areas in which the Fund has concentrated its investments are light manufacturing, including printing, packaging, knitwear, welding equipment and food production such as mini-bakeries and bread factories.

THE U.S. RUSSIA INVESTMENT FUND (TUSRIF)

Address: Ul. Italianskaya 5, office 53. 190000, St. Petersburg.

Tel.: (812) 315 7035 Fax: (812) 315 8264

Vice-president: Ilya Karasev

Webpage: <http://www.tusrif.ru>

TUSRIF is a private investment fund which provides loans, investments and technical assistance to privatised Russian enterprises of any size as well as to Western firms and joint ventures working in Russia. It was set up in May 1995 by merging the Fund for Large Enterprises in Russia and the Russian-American Enterprise Fund. It has been initially funded by the U.S. Congress through grants from USAID amounting to \$440 million. The fund has offices in New York, Moscow, St. Petersburg, Rostov-on-Don, Yekaterinburg, Khabarovsk and Vladivostok. TUSRIF also has a Small Business Lending Programme which operates through a network of Russian banks. In its five years of existence the Fund has invested more than \$200 million in thirty big firms and more than 2,000 small firms (Delovoi Peterburg, 2000: 5).

## **6. SMALL BUSINESS IN ST. PETERSBURG: EVIDENCE FROM QUALITATIVE INTERVIEWS AND INFORMATION PROVIDED BY ORGANISATIONS WHICH COMPLETED THE QUESTIONNAIRE**

### **INTRODUCTION**

The dearth of reliable data makes field work essential to gain a more accurate picture on small business in today's St. Petersburg. Organisations dealing with small businesses were asked to complete a questionnaire in order to have a picture of the firms they work with. Although they are not fully representative of the small business population in St. Petersburg, they can nonetheless provide interesting information on data not covered by the official statistics (export propensity, origin of purchases, etc.). By comparing these results with surveys covering the entire population of firms one can estimate how much the sample is representative. Interviews were also carried out with a variety of economic actors (entrepreneurs, representatives of organisations promoting small business, academics and local officials). The interviews did not follow any precise pattern, but rather a free discussion concentrating on the most interesting topics which arose. The names of the entrepreneurs interviewed have been replaced with aliases. This section analyses the most relevant aspects (starting up, financing, relations with the public administration, taxation, operations, markets and performance) which were raised in the interviews.

### **6.1. EVIDENCE FROM QUALITATIVE INTERVIEWS**

#### **6.1.1. METHODOLOGY**

Several interviews were conducted in the period August 1997-October 1998 with individual entrepreneurs and representatives of organisations promoting small businesses, some of whom were met two or three times. The aim of the interviews was to delineate the main factors affecting small business in St. Petersburg and to see how small firms coped with adverse

conditions. With entrepreneurs the discussion focused on their experiences as business owners, investigating in depth the most interesting points which arose in the course of the discussion. Representatives of the organisations were asked to fill in a questionnaire. Those who declined were nevertheless interviewed in the hope that they may supply useful information about working with small businesses. The seven major areas that were covered are analysed in the following sections, which also include the replies to the questionnaire pertaining to these areas. These include the start-ups process, the three major problems indicated by entrepreneurs (financing, relations with public administration, taxation), the firms' organisation and the market outlook for small firms. Interviews with the following entrepreneurs and representatives of organisations (those who filled the questionnaire are listed in section 6.2) were carried out:

- T. B. general director of Fitolon, a scientific-industrial company. It was founded by a former director of a textile company in 1992 together with a group of researchers in medicine in order to unite their skills: her capacity as a manager and their competencies in the field of chemistry and the technology of production of medical-preventive preparations from herbs. The purpose of the firm is to manufacture medicines patented by them. At the beginning they also did research for other firms and with the earnings from this activity they were able to finance the production of their own medicines, which are derived from seaweed. They own fifty patents and among the staff have five researchers. Their clients are mostly chemist shops and to a lesser degree hospitals, as hospitals have limited resources to buy medicines. About 25% of their sales are in St. Petersburg and the rest in over thirty cities in Russia. It would be very difficult for them to export even to nearby countries such as Belarus and the Ukraine because the documents required by customs are very complicated. Soon after our interview their products should have become available in Israel and Egypt, since joint agreements had been reached with local firms for the production of their medicines in these countries (December 1997).

- E. C., general director of Melp, a scientific-industrial company. The firm was created to produce a device which removes oil from dirty water, but it has subsequently turned to the production of medical equipment: a low-temperature gas sterilizer of medical products. The production of the latter was started in 1997 as they received the certificate of conformity issued by Gosstandart (the standard authority of the Russian Federation). Melp is the only manufacturer of this kind of equipment in Russia which has the advantage of being ecologically clean and safe. Only the engine is produced in house, while the remaining parts are manufactured by other small firms. Their economic situation is very difficult since their main clients, hospitals, have seen the municipal allocations decrease year after year<sup>1</sup> with the result that they can hardly afford to buy any new equipment. For this reason they do not have the money to obtain the certificate also for the other 4-5 products they designed. Each certificate costs \$10,000. (June 1998).
- S. H., general manager of Slavia, a publishing house, set up in October 1990, specialising in prestigious art books. It is the official publisher of the catalogues for the exhibitions held in the Hermitage. In 1997 Slavia published twenty books regarding the Hermitage or exhibitions taking place in the Hermitage and seven books on other subjects. While their earlier books were in Russian with resumes in foreign languages they have now moved on to publishing directly in different languages, since a considerable share of their clients are foreign tourists. In the 1996 book exhibition in Frankfurt agreements were signed with publishers from Italy, France, Germany, United States, Japan, Poland and Portugal for the sale in these countries of a book on the Hermitage prepared by Slavia, and for other joint projects. They have also published a book on painting with an Italian publishing house (December 1997).
- O. L., general director of Acvasviaz, a company set up in 1991 which develops, produces and delivers security signaling systems. It works in a potentially lucrative market: theft-proof devices and anti-fire equipment.

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<sup>1</sup> The city budget has allocated 5 million roubles (slightly less than \$1 million) in 1998 to buy medical equipment. This means one rouble (16 cents) per citizen, while in order to

Since the former were unknown in the past their demand is bound to expand greatly in the future. The same applies to the demand for the latter which has become compulsory by law for a factory. Despite the potential the company is in dire financial straits (December 1997, March and June 1998).

- M. M., general director of Gefest, a furniture producing firm, one of the first co-operatives to be set up in the city in 1988 (December 1997).
- T. P., director of BMN Peterburg, an advertising agency created in 1992, which is also the official information centre of the St. Petersburg Association of Professional Stock Brokers. Ms. T.P. is the representative of "*Business Week*" in St. Petersburg as well. The agency, unlike the majority of agencies in St. Petersburg, offers a wide range of services, from simple tasks such as the design of logos, visiting cards and small advertisements to a complete set of marketing initiatives. Their clients have included important institutions such as the Russian Centre of Privatisation, the Property Fund of St. Petersburg, the Russian Institute of Radio Navigation and several banks. The staff is currently made up of twenty people, but was reduced in 1996 due to financial difficulties (December 1997).
- E. R., chief accountant of R.<sup>2</sup>, a firm developing and producing remote-controlled mechanical systems for x-ray and optical applications as well as separate components for these systems. The firm was set up in 1991 by four private individuals - one of whom is the current director - who had experience in x-ray equipment and their applications. They are located in a factory producing the same kind of equipment. These are meant only for industrial use and are made-to-order. The firm has an agreement with the firm which owns the factory by which the other firm can sell only in Russia and R. can only sell abroad except for a few clients in Russia, which do not make more than 5% of the total turnover. Their main markets are the United States, Australia, Germany and Korea

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replace worn-out equipment it would be necessary to spend 120-150 million roubles each year (Kudriavziev, 1998: 10).

<sup>2</sup> The interviewee requested the name of the firm not to be published

and their clients are private firms as well as universities and scientific centres (June and December 1998).

- the sales director of Parmalat-Russia<sup>3</sup> (June 1998).
- Thomas Oetter, a consultant working for the EBRD Small Business Fund (March 1998).
- Valentine Galenko, director of the Higher Economics School, part of the University of Economics and Finance, which organises training courses for entrepreneurs (December 1997).
- Alexander Kizhin, deputy director of organization at the Higher Economics School (March 1998 and October 1998).
- David Kerry, country director of International Executive Service Corps (December 1997 and October 1998), a USAID-funded organisation which provides consulting to small Russian firms.
- Constantin Pechatnikov, director of Business Development Centre of the Vyborgskii district (March 1998), an organisation set up by the State Committee for the Support and Promotion of Entrepreneurship to provide consulting to small firms.
- Constantin Eskin, deputy director of the Committee for Economy and Industrial Policy of the St. Petersburg administration. (June 1998).

### **6.1.2. STARTING UP**

The firms of the entrepreneurs interviewed are old by local standards. The oldest was created in 1988, and the others between 1990 and 1992. The activities of the firms researched are connected with the previous occupations of the entrepreneurs. When the opportunity arose to start private firms they left their state occupations together with some colleagues and set up a new firm. In publishing, for example, many like Ms. S. H. left the state publishing house, Aurora, specialising in prestigious art books, to start their own publishing houses. Aurora, which had a monopoly on books on the Hermitage and other museums of St. Petersburg, has since lost much of its market to newcomers and survives mostly on sales abroad. Some

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<sup>3</sup> The interviewee requested his name not to be published.

interviewees claimed to have been induced to set up a firm by the lack of prospects in their previous job, mainly those working for the defence sector (E.C. and O.L.), but most seem to have been pushed by the common desire to exploit new opportunities. Only one, O. L., indicated as a driving force the sense of frustration he and his colleagues felt because the inventions they were producing were not utilised in the defence sector. They wanted to work without public officials dictating what to do, and who were then unable to put their inventions to productive use.

The main deterrents perceived to the creation of new firms are the high cost of setting up a firm and the time-consuming procedure. In the scientific sphere, for example, at the beginning of 1998 the cost of becoming a legal entity, registering a patent, obtaining a certificate for a given scientific product and buying a licence to carry out a given activity was about 80,000-90,000 roubles (\$12,000) which is prohibitive for the average citizen. For firms not registering patents the costs are lower, but the amount is equally beyond the reach of most Russians. The entrepreneur working in the furniture business remarked that the cost of the certificate necessary for each item is so high that it is hardly convenient for a small firm to operate in this field.

The procedure is especially complicated for manufacturing activities which require an array of permits from various departments of the city administration. In the opinion of O. L. and M. M. the procedure has become even more complicated now than in the past. The administration itself, according to Kerry, cannot specify all the documents required to start up a business venture. The entrepreneur needs to contact all the separate departments of the administration and find out what each committee wants. One is shuttled around among the different city committees, all requiring different things.

In retail obtaining all the necessary licences is somewhat less complicated, while the main constraint according to Kerry is the protection racket. Unless

one has a “roof” it is not possible to operate. The need for protection seems to affect manufacturing businesses less mainly because they are (rightly) considered much less profitable than trading activities and also because they are less visible. Such firms are usually located in small units within large factories, and can avail themselves of the protection afforded by their landlords. Racketeers visit the firms to check the accounts (the real figures, rather than the official records) and it is difficult to refuse. On the basis of this they decide how much a firm can afford to pay. In recent years there has been a shift from racketeering to organised protection. Some former criminals have now set up legitimate security firms which freely advertise their services. Others have been founded by former policemen and KGB agents. In general business relations have become more civilised after a period of “wild market” in the early 1990s, but in order to solve problems of non-payment with clients it is still customary to employ security firms. In the early 1990s several groups vied for the same area of influence with the result of frequent shoots-outs. In this chaos entrepreneurs did not know who to pay. Now each part of the city is under the control of a single group. However, it is hard to say how pressing this problem is in St. Petersburg as entrepreneurs hardly mention the menace of criminal groups.

The exploitation of business opportunities is also hindered in Kerry’s opinion by the lack of understanding of the potential of forms of business collaborations such as franchising. The International Executive Service Corps has been trying to promote franchising for the last three years, but almost to no avail as Russians did not demonstrate any interest. They only managed to sell the first licence shortly before our last meeting (March 1999).

Official statistics indicate a regular increase in the number of small firms in industry, although at a lower rate than service firms, a view which is supported by the majority of the people working for the organisations dealing with small businesses. Representatives of these organisations see small business expanding especially in the following industrial sectors:

food, construction materials, printing and publishing. The second half of the 1990s has seen a process by which wholesalers who have amassed a considerable fortune through trading have been investing in the production of some of the goods which they used to import from abroad. However, almost all agree that small business will develop slowly. In the present Russian conditions it is hard to find anyone forecasting fast growth in this sector. The same conclusion was shared also by the participants in the first Russian Congress of Entrepreneurs held in 1996 (Blinov, 1998: 27). The perceptions of the entrepreneurs are, instead, different. They have the impression that small industrial firms are decreasing in numbers. O.L. knows of many engineers who, like him, started their own firms at the beginning of the 1990s, but about one hundred of these have subsequently closed. He believes that more small industrial firms are now<sup>4</sup> being closed than opened. This opinion is also shared by M. M. The reason for the divergence in opinion may be connected with the high failure rate of small businesses. Manufacturers see many of their competitors closing down and have the perception that small businesses are decreasing, but are less aware of the new start-ups. In the opinion of Oetter, 80-90% of all new enterprises fail within one year in Russia, and anecdotal evidence of industrial managers also suggests a high failure rate (see also page 112 on this topic).

Although there are no statistics on the matter the common perception of the people interviewed is that most new industrial firms are located within larger enterprises. According to Kerry and Oetter, new firms are mainly created by spinning off parts of a company or renting or acquiring equipment from these, rather than through new greenfield investment. Russian entrepreneurs try to utilise what they already have, rather than setting up a new company from scratch. This kind of investment is, in their opinion, mainly financed by foreigners. In many cases, the aim of the spin-offs is to divide the profitable sections of a factory from the unprofitable. These new companies, which inherit the best equipment, start debt-free,

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<sup>4</sup> Now refers to the period in which the interview was conducted (June 1998).

leaving all the liabilities and the least profitable equipment to the old company. All this is perfectly legal. Some of the spin-offs are, however, set up not because it makes sense from an economic point of view to divide a big factory into several smaller units, but for more selfish reasons. Kerry pointed out that there have been cases in which managers have spun off a new firm, regardless of economic rationale, just to award themselves higher salaries as managers of these new firms.

Another problem mentioned in the interviews is that unpredictable events can occur at the very last moment and postpone the start of an activity or turn a seemingly profitable business into a failure. Unexpected taxes can be levied or tax advantages previously conceded unexpectedly revoked. Kerry mentioned the case of a company (presumably foreign) which wanted to invest in St. Petersburg, but finally decided to locate the plant in Novgorod because local conditions were more favourable there. However, when the plant was ready to start functioning, the Novgorod power company said that it could not supply energy because its capacity was already over-stretched. In another case, Coca-Cola, which has built a plant in the outskirts of St. Petersburg, had to postpone the launch because the fire inspectors did not give the go ahead<sup>5</sup> until a fire station was built in the factory.

### **6.1.3. FINANCING**

In a country where savings were wiped out by the hyper-inflation of 1992-1993<sup>6</sup> and where financial institutions are very wary of financing new enterprises, having the financial resources to start up a firm is beyond the possibility for most. According to a survey carried out in 1996 by the St. Petersburg branch of Goskomstat just 4% of the 260 entrepreneurs surveyed had obtained the initial financing from banks and 1.2% from state

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<sup>5</sup> Russia has very complex fire regulations which are almost impossible to follow. Probably no industrial site fulfills all the conditions set by the fire code. The interviewee seemed to imply that the crux of the matter was that Coca-Cola refused to make side payments to fire authorities.

<sup>6</sup> Bank deposits were not indexed to inflation.

institutions (Goskomstat, 1996d: 5). In the opinion of Melnikov, the vice-director of a science park, there is a considerable potential for scientific entrepreneurship which is not exploited due to lack of financing. All but one of the representatives of the organisations interviewed indicated the lack of initial capital as the main obstacle to starting a business, a finding common to almost all transition countries (Dimitrov and Todorov, 1995: 67; OECD, 1996b: 47-56; Zapalska, 1997: 115; Bohata and Mladek, 1998: 155; Bartlett and Rangelova, 1998: 239; CCET, 1998: 21; Smallbone and others, 1999: 17)<sup>7</sup>. Even in countries such as Poland, which has seen a very strong growth of small businesses, the financial sector has given little assistance to small business: short-term loans are very expensive and just 10% of new firms receive any bank financing at the start-up stage (Webster, 1999: 13).

In Russia, according to the majority of the organisations' representatives interviewed, banks are not thought inefficient, but are accused of charging high interest rates on borrowing and of being very reluctant to concede loans, especially long-term loans. Ramsden, however, emphasises that it has become easier to receive long-term loans in recent years. The difficulty in obtaining loans lies in the fact that banks require guarantees which very few people are able to provide. A guarantor for a loan can be found at a cost, but, adding this to the loan makes the overall cost of borrowing prohibitive as interest rates in Russia are very high. On the other hand, the banks complain of poorly formulated business plans and the high risks of these ventures. Even the EBRD programme for small business tends to finance existing businesses, since new businesses are seen as too risky.

Two of the firms interviewed had received financing from specialised funds (the two scientific-industrial companies), but none at the start of their activity. A common feature of these firms is the low level of investments carried out, as the limited cash flow does not usually allow them to make new investments. Due to financial constraints, Acvasviaz could market just

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<sup>7</sup> Dimitrov and Fodorov refer Bulgaria, the OECD refers to the Czech Republic, Slovak Republic, Poland and Hungary, Zapalska refers Poland, Bohata and Mladek to the Czech

five of the eleven products it had developed. None had the resources to buy new equipment. At the time of the interview one used equipment it had built and rented only the premises where its equipment was located (Acvasviaz), one rented equipment from the host factory (R.), one utilised very old equipment, some owned by the university and some of its own (Melp), and one had contracted out the production (Fitolon). The only company considering investments was the last company, which was looking for second-hand equipment, but this had been forced upon them, as the factory to which their production was sub-contracted had told them it was no longer able to do the job.

#### **6.1.4. RELATIONS WITH THE PUBLIC ADMINISTRATION**

In Russia the government is viewed as hostile, or at best indifferent, to small business by almost all the representatives of the organisations interviewed. Government programmes and laws adopted to promote small business were judged of little or no effect by all respondents, except one who recognised that some progress has been made, indicating the law on leasing, as an example. Very few firms on which these organisations gave information have benefited from any state programmes. Even in other transition countries it seems, however, to have been difficult to implement effective assistance programmes which are appreciated by small businesses (Erutku and Vallee, 1997: 117).

As far as St. Petersburg is concerned, being the most westernised Russian city has not meant that business is less affected by bureaucratic obstacles than in the other regions. The representatives of the organisations interviewed judge the attitude of local officials negatively, although no worse than elsewhere in Russia. Most of the entrepreneurs interviewed are equally very critical of the administration of St. Petersburg, which is accused of doing nothing for small business; by contrast they have a high opinion of the Moscow administration. There is a widespread belief that the

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Republic, Bartlett and Rangelova to Bulgaria, the CCET to Russia, and Smallbone and

Moscow administration cares much more about small business and that it is therefore much easier to receive loans, to find premises at advantageous terms, to lease machinery and equipment, etc. The mayor, having been the director of the Committee for the Support of Small Business in the late 1980s, is considered to be very receptive to the problems affecting small businesses. As emphasised by Galenko, the scant consideration that small business receives from the administration of St. Petersburg was proved in the 1997 congress of the city's small businesses in which 1,000 people, mostly entrepreneurs, took part. High level representatives of the Moscow administration attended the congress, including the deputy mayor, but nobody from the higher echelons of the St. Petersburg administration.

What is peculiar about Russian business is the amount of time that needs to be dedicated to dealing with regulatory bodies, which are a constant nuisance to entrepreneurs. The control exerted by the different institutions in charge of regulating business activities is viewed as excessive. Some complain of being subjected to continuous inspections by different authorities, which may result in the entrepreneur being obliged to make side payments. Corruption by official bodies is a significant problem for all the entrepreneurs and in the opinion of M. M. it is worsening every year. He set up one of the first co-operatives in St. Petersburg in the late 1980s and believes the situation to have been much better then than in the late 1990s. However, corruption is a phenomenon plaguing the whole of Russia which will be difficult to eradicate as long as the central government is seen as the prime culprit and unclear laws leave ample space for it.

In sectors such as advertising the local administration is said by one firm to favour well-connected firms and to require side payments. To hang a billboard it is necessary to obtain the approval of the territorial committee of the city (St. Petersburg is divided into several territories), but this necessitates a bribe to a local official. An official can cite faults in the design of the billboard (usually a small detail) and offer to make the

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others to the Ukraine.

modifications for about \$50. The director of the agency interviewed was stunned recently when her firm was asked for \$200 for "modifications", which is 40% of what they were charging the client.

In advertising many of the first firms to have been set up in St. Petersburg were started by former members of the Communist Youth Organisation, since at the beginning of the economic reforms they were the people who tended to have money and good connections. The three biggest advertising agencies in St. Petersburg were still at the end of 1997 owned by former members of this organisation. These three agencies obtained their first clients from the city administration and even today if somebody asks the city administration for advice he will be sent to one of these firms. They are accused of using scare tactics to defend their monopoly positions on the best clients. In the past, when the agency of the interviewee was recommended to a Moscow bank, one of the three main agencies warned her not to take this client on. Because of this, the interviewee gave up this opportunity as she felt helpless in the situation. In her opinion it is no use to call the police for help, because these well-connected firms are in effect above the law. Apart from this incident, however, crime does not seem to have affected this or the other businesses, but it might be the case that the entrepreneurs have been reluctant to speak about protection rackets.

Problems with the city administration also stem from its slowness in taking decisions. According to Kerry, public officials often purposely avoid making decisions because they see it as a risk, as signing a document entails taking on the responsibility for it. If the official leaves for any reason, his successor may disclaim responsibility for anything his predecessor signed, and the whole process needs to be repeated. The administration is also accused of having increased rents to a level that small businesses are not able to sustain and not containing utility expenses, which continue to rise. Indeed, according to a survey carried out among entrepreneurs the rent increases are considered a very urgent problem (*Predprinimatel' Peterburga*, 1998, no. 14: 3). However, the mass closure of small firms that these

increases were expected to bring about, according to the entrepreneurs, has not taken place.

### 6.1.5. TAXATION

According to the representatives of the organisations interviewed two problems emerged predominantly as the biggest facing existing small businesses: taxation - not only the tax burden, but also the arbitrary enforcement of tax laws - and the lack of state support. Having taxation as the main difficulty for entrepreneurs is, however, not solely a Russian prerogative, as it is listed as the single most important problem in almost all transition countries (Dimitrov and Todorov, 1995: 67; OECD, 1996b: 47-56; Bohata and Mladek, 1998: 155; Bartlett and Rangelova, 1998: 239; CCET, 1998: 21; Smallbone and Welter, 1999: 8)<sup>8</sup>, although recent evidence produced by Smallbone (as quoted by Smallbone and Welter, 1999: 13) suggests that in countries which have reached a more advanced stage of the transition process, such as Poland, taxation has now become less pressing in comparison with market-related problems such as competition. Two of the three main problems indicated in 1992 in Webster and Charap's (1993: 4) survey of St. Petersburg - inflation and the ineffectiveness of the banking system<sup>9</sup> - have disappeared from the list, while the other problems mentioned are broadly unchanged: lack of managerial skills, which is the number one problem for TUSRIF, unreliability of suppliers, the unstable situation in the country, and the lack of training, reliable market information, infrastructure and circulating capital. Given the above responses it is not surprising that tax reform and

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<sup>8</sup> Dimitrov and Fodorov refer Bulgaria, the OECD refers to the Czech Republic, Slovak Republic, Poland and Hungary, Bohata and Mladek to the Czech Republic, Bartlett and Rangelova to Bulgaria, the CCET to Russia, and Smallbone and Welter to Belarus, the Ukraine, Moldova, Poland, Hungary, the Czech Republic and the Baltic States.

<sup>9</sup> In the early 1990s banks charged about \$100 to open an account and required high fees for simple transactions (Webster and Charap, 1993: 53). This situation has now improved, but the losses of deposits incurred by the clients of several of the major private banks show how unreliable many Russian banks are.

the carrying out of a programme of real support to enterprises are advocated as the most pressing measures to promote small business.

The defining features of the tax system in Russia are high taxes and special privileges, which big firms are able to obtain through their political influence. For these reasons every company keeps two sets of accounts: a real one and one for tax purposes, without which, according to the entrepreneurs, it would be impossible to survive. In addition to sales, assets are also undervalued in the balance-sheets in order to reduce taxation on business property. Therefore when, for example, machinery is bought from abroad a Russian firm usually asks for two bills, one for the tax and customs and one for what it has to pay. Up to now this system is working because there is no link between Western and Russian taxation bodies.

Another serious inconvenience is that laws may also be retroactive. A law approved in March may be effective from the previous January with the consequence that a firm has to rewrite all its accounts from January, otherwise it can be fined. Entrepreneurs are especially critical of the behaviour of the tax inspectors, complaining that each company is in effect dependent on their will. There is a tendency from tax inspectors to try to get as much as possible out of the private sector without considering the wealth-generating function it performs, and to interpret freely the tax laws, as there is no sanction against officials who misinterpret laws. According to the entrepreneurs interviewed some of the tax advantages for small business exist only on paper, because to avoid firms exploiting the tax privileges they are entitled to, tax inspectors, as a norm, require excessive documentation and make life impossible. In the opinion of entrepreneurs tax inspectors always strive to demonstrate that firms do not have the right to these advantages and it is very difficult for a small enterprise to demonstrate the contrary. Usually entrepreneurs try to settle this matter directly with the taxmen, even to the extent of bribery, without resorting to the courts, as they believe that in the courts they have little chance of defeating the tax

inspectorate<sup>10</sup>. Due to the intransigence of the inspectorate, entrepreneurs see little point in switching to the simplified system of taxation and accounting for small firms. This system does not seem to be very convenient in any case, as in the opinion of the chief accountant of Slavia and of E.R. the only real advantage offered is the possibility of paying taxes at a later date. In practice, according to them, the only privileges they have as a small business is that they can pay the profits tax quarterly instead of monthly, as prescribed for larger firms, and that the profit and loss accounts do not need to be as detailed as for larger firms. No details are necessary, for example, regarding the amount of sales to each client, while big firms have to list their sales to each client. According to the chief accountant of Slavia, current tax advantages amount to 5% less than of the tax bills of large firms.

There is conflicting evidence as to whether the business environment has improved or not compared with three years ago. Representatives of the organisations are, as a rule, more positive or at least less negative, while entrepreneurs have a less optimistic outlook. Only one entrepreneur considers the tax system and the business environment to have improved in recent years. For the director of BMN, tax legislation has become clearer than in the early 1990s when they started their activity. This had caused huge problems with tax inspectors in the past, but these problems have now subsided. The first time the firm was checked by tax inspectors, it was fined on the grounds that their accounts were not kept properly. Subsequently a second inspector came and told them they had to do the accounts in a different way, so they were fined again. This has happened several times in the past.

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<sup>10</sup> There may be an element of exaggeration in what they say. For example, in the arbitration court 40% of the disputes are lost by the tax bodies (Sergachev, 1997b: 15). In recent years judges in arbitration courts are said to have become more experienced in tax matters and to issue more balanced judgment based on more strictly legal interpretation rather than on the opinions of the tax bodies (Antel, 2000: 2).

### 6.1.6. OPERATIONS

In a market where instability is the rule flexibility is essential to survival. For this reason, in several firms the full-time staff is limited to the bare minimum, just the administrative and clerical personnel, while workers are employed only when there is an order (Melp and Acvasviaz), or the industrial job is contracted out (Fitolon). The number of employees varied from four in Melp and six in Acvasviaz to fifteen in R., twenty in BMN, twenty-five in Fitolon and twenty-seven in Slavia.

Most of the entrepreneurs complain of the administrative burden of having to comply with the tax system. This means that much time has to be dedicated to these issues and a disproportionate share of the employees are accountants. A lot of tedious forms must be filled in. Slavia, for example, had four accountants among the thirteen employees working in the main office and the companies, such as Acvasviaz, which has just one accountant among its six employees, must use tax consultants. Every firm, irrespective of how small it is, had at least one accountant.

Representatives of the organisations (Kerry, Karasev and Nekludov) consider the lack of management skills to be one of the main problems for these firms. Russians are especially weak in financial management and planning, market research, and in developing business plans. In Kerry's opinion, almost any small company in St. Petersburg would require Western assistance, as they often lack the capacity to find the solutions even to simple problems. One factor which emerges is the lack of primary market analysis. According to several of the interviewees (Kerry, Eskin), people may create a company only to find out that there is no market for what the firm plans to produce. This is a factor which has also been underlined both by the executive director of the Svetlana Science Park and the head of the Regional Fund for the Scientific and Technological Development of St. Petersburg as the main fault in the business plans submitted to financial institutions (Pashnov, 1996: 15). That is why the proportion of projects

approved by the funds active in St. Petersburg is very low. Specialised funds financing small ventures approve about 3-6% of the total number of projects submitted. TUSRIF approves 6% of projects submitted for equity investments and 3% for loans and the Small Enterprise Equity Fund 3% (Borisova, 1997: 10). Marketing and sales departments are usually lacking or are staffed by one of the founders, despite the fact that Russian entrepreneurs have strong technical expertise, but are usually deficient in other areas. On the other hand, it must be borne in mind that a marketing specialist can hardly be afforded by most small industrial firms, but even when a company has the resources marketing does not seem to be a priority. There may be, however, a shortage of skilled specialists, as analysis reported by Pechatnikov (1998: 39) showed that two-thirds of the service firms dismiss workers within one year of their recruitment, mainly due to the lack of job qualifications. In spite of the fact that the St. Petersburg's population enjoys a very high level of education, the major employment-related problem is the lack of skilled personnel according to 30% of directors of enterprises. The second and the third are the difficulties in dismissing surplus staff and the low productivity (Strategiski Plan Sankt-Peterburga, 1998: 30)

#### **6.1.7. MARKETS and PERFORMANCE**

According to three of the interviewees (Haval, Paouk and Liubomirski) the main problem in St. Petersburg is the limited purchasing power of the buyers. There is a palpable resentment towards Moscow, which enjoys a much higher standard of living at the expense of the rest of Russia, in the opinion of almost all those interviewed. A constant remark is that 70-80% of the financial resources of the country are concentrated in Moscow<sup>11</sup>. Salaries are said to be several times lower in St. Petersburg than in the capital.

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<sup>11</sup> This is a widely held view indicated also in academic literature (Pimoshenko, 1996: 54).

The only data available on turnover are on Slavia, \$2.5 million, Acvasviaz, \$300,000 and BMN, the only service firm interviewed, \$170,000<sup>12</sup>. This means a turnover per employee of about \$100,000 and \$50,000 for the first two, very large by Russian standards, while BMN (the advertising company) had an average turnover of \$8,000 per employee, about the average figure for Russian small businesses.

No figures were given as to profitability, but all complained that production is hardly profitable. Firms which are doing better are those which sell directly to the consumer or to retail outlets and have a distinct image among consumers, such as Fitolon and Slavia. The latter is in a specific market niche - prestigious art books - and for this reason Slavia publishes only very expensive books in order to maintain its image. Slavia did not have a specific market niche at the beginning of its activity. It started by printing books on French painters. In those years the new publishing houses were quite erratic in their choice of material. Since then the market has become very segmented, and the majority of firms have specialised in a particular market area. In the art field there are currently three or four publishers in St. Petersburg which have divided the market among themselves according to the price range. Slavia has focused on the top of the market, while another specialises in medium-priced books and the others in cheaper books. Slavia has several stalls in the Hermitage, having been chosen as official publisher of the catalogues for the exhibitions held there, a status much sought-after by several competitors. This was actually the turning point for their activity. According to Ms. S.H. the decisive factor was that they volunteered to publish some trial catalogues for the Hermitage free of charge. Appreciating the quality of these catalogues, the Hermitage awarded them the right to be their official publisher. Currently, 70% of their books are sold there. Around 20% are sold in the only two bookstores in St. Petersburg where their books are on sale: Dom Knigi, the most famous bookstore in the city, and their own bookshop. New bookshops are being opened in great numbers, but Slavia prefers to sell its books only in a few

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<sup>12</sup> The first two figures refer to 1997 and the last to 1996

outlets. The remaining 10% are sold in Moscow, while in the other parts of Russia their books do not have a market, since their customers - the Russian intelligentsia and foreign tourists - are mostly concentrated in the two biggest cities.

Similarly, Fitolon sells only medical-preventive preparations from herbs patented by them and has become a well-known brand, also conducting a promotional programme on television. The other firms have been badly affected by the worsening economic situation. For some survival is heavily in doubt. In worst shape are those selling to industrial firms, such as Acvasviaz, or to budget-financed institutions, such as Melp. The turnover had fallen by a factor of two or three for these firms in the two or three years prior to the interview. Melp was late in the payment of the loan received by one of the Funds financing technology-based firms, despite obtaining the premises and part of the equipment almost free from the university<sup>13</sup>. The advertising agency was also in a deep crisis and did not have the money to pay the wages for the current month, as its main clients were in bad financial situations and had to cut costs, including advertising. R. is a case apart, because 90% of its market is abroad. They were, however, also performing poorly because the former director, who had a lot of contacts, has emigrated to the United States. In addition, they were strongly affected by the new regulations introduced after the August 1998 crisis which are seriously penalising exporters. It became compulsory to sell 70% of export receipts within three days at an exchange rate which is much lower than the market rate, while before the crisis it was necessary to sell 50% at a rate only slightly lower than the market one.

The environment is characterised by unpredictability and firms have to face events which in the West would be highly unlikely. One firm (BMN) is resigned to having lost a substantial amount of money because a major bank of St. Petersburg, one of its clients, on behalf of which it had anticipated the

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<sup>13</sup> The founders are academics of these university. Since they cannot afford to pay the rent they made an agreement with the university by which the university does not pay them the full wage, but the firm can utilise the university premises almost for free.

payment of advertising, found itself in financial difficulties and is unlikely to pay back the debt<sup>14</sup>, another firm (Acvasviaz) was almost bankrupted at the beginning of its activity because a state institution could not pay for what it had ordered, not having received the funds from the budget, the market niche targeted by a third company (Melp) disappeared in 1995-1996 after a few years of work because industrial clients no longer had the resources to spend on the ecological treatment of water and, according to the company's director, resorted to throwing water away without cleaning it, despite this being illegal. For this reason this firm turned to the production of medical equipment. The problem of the lack of compliance with the law also seriously affects Acvasviaz which has a potentially large market, as the installation of anti-fire equipment is compulsory. However, few firms can currently afford to abide by the law, since most Russian industries are in a very bad economic condition, and for this reason resort to bribing inspectors rather than complying with the regulations.

The quality of their products is seen by the manufacturers interviewed as comparable to Western standards, with the advantage of being much cheaper. This assumption is shared by several representatives, but not all, of the organisations interviewed. According to Karasev, regional director of the U.S. Russia Investment Fund (TUSRIF), the Russian market is divided into three segments: cheap products imported from Asian countries such as China and Taiwan; reliable and durable, but unattractive, Russian products and expensive imported products. He evaluates Russian products as not inferior to foreign ones in quality, but not well designed. It also seems that Russian consumers, who used to have a very low opinion of domestic products, now have a higher regard for domestic goods, which are not necessarily thought worse than foreign equivalents, according to a recent survey carried out by the Stockholm School of Economics in St. Petersburg (Shcherbakova, 1999a: 9).

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<sup>14</sup> This happened before the financial crisis of August 1998.

In recent years there has been a constant rise in the penetration of domestic goods. The first phase of economic reform was accompanied by a flood of imports which squeezed domestic products out of the market in many sectors. Better looking, but not always of better quality, these foreign goods easily took the place of domestic products exploiting the novelty factor and having at their disposal much larger advertising budgets. This wiped out whole sectors of the economy such as light industry, where production levels are still at a fraction of the pre-reform levels. The penetration of foreign products reached its peak in 1995 when, according to official data, they accounted for 54% (Russian Economic Trends, 1999, no.1: 102) of retail sales. Since then, a counter trend has developed. Slowly in 1996 and 1997, and much more quickly after the devaluation of the rouble, Russian products have gained a larger market share. In 1998, their share of retail sales reached 57% (Russian Economic Trends, 1999, no.1: 102). Since devaluation domestic products have made large gains, as demand has shifted towards cheaper products and this has benefited Russian goods. For example, food imports are estimated to have fallen by 50% compared to the levels prior to August 1998 (Shcherbakova, 1999b: 1).

According to the director of Fitolon, while in 1994-1995 all the medicines on sale in Russia were foreign-made, the population is now (December 1997) rediscovering Russian medicines that in her opinion are better and less expensive<sup>15</sup>. She is convinced that there is now more room for domestic producers in the Russian market, but complained that the popularity of their medicines is being exploited by some of their competitors who use brand names closely resembling theirs. The weak legislative system provides few guarantees against this behaviour, even if the firm has patented all its products. Gains in the market share by domestic products have also been strong in the food sector, in the opinion of several of the interviewees (Oetter, Siling and Kerry). Oetter cited the example of a wholesaler specialising in the food sector, which had already reduced the share of

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<sup>15</sup> This is confirmed by a report of the U.S. Department of Commerce – International Trade Administration which includes pharmaceuticals (together with foods and beverages) among

imported produce from 70% in 1996 to 50% in 1997, and was planning to reduce further to 30%. According to the sales director of Parmalat's Russia subsidiary, some Russian companies, which were twenty-thirty years behind Western firms in production and marketing, have almost caught up in the space of two-three years to 1998.

In sophisticated goods such as household appliances, a Russian brand can, however, still be an handicap, as also indicated in the Stockholm School of Economics' survey<sup>16</sup>. The much larger advertising budgets of foreign firms give them an edge over domestic competitors. Liubomirski complains that it is very difficult to sell his products in the shops because Russians tend to prefer foreign brands, while this problem is not felt with industrial customers, because of their quality reputation.

There are still, however, segments of the market where supply is insufficient compared with demand, for example high-quality work from typographies. There are only three typographers in Russia capable of printing high quality books: one in St. Petersburg and two in Moscow, but owing to high demand they are able to charge very high prices. In addition, none of them can guarantee timely delivery due to the great workload, so that it is necessary to order work well in advance. Because of this it is cheaper and more reliable for Slavia to resort to typographers in Italy or Slovenia. In fact, the critical factor in their success is good timing. Exhibitions are usually announced at short notice (i.e. two months) and it is important for them to have the book ready when the exhibition begins because it is in the initial days - when the new exhibition is reported in the local media - that most of the sales are accounted for. A delay in printing would mean that a great deal of the books remain unsold.

Only one of these firms export abroad, but two (Slavia and Fitolon) had signed agreements with foreign firms for production and sale abroad.

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the sectors where local producers made more inroads even before the rouble devaluation in August 1998 (Bisnis, 1998: 8).

<sup>16</sup> The Stockholm School of Economics has a branch in St. Petersburg.

Exporting is still very difficult, because the Russian name is synonymous with bad quality abroad, and because of the high cost of acquiring a foreign certificate and of the perceived unreliability of Russian firms. However, if it is true that Russians have not yet fully acquired Western working habits showing for example little respect for deadlines in Kerry's opinion this unreliability is often due to external circumstances. Russian firms may have very good intentions when signing a contract, but unforeseen problems, such as a sudden change in the customs law or a drying-up of the cash flow, may make them unable to fulfill the terms of the contract.

## **6.2. INFORMATION PROVIDED BY ORGANISATIONS WHICH COMPLETED THE QUESTIONNAIRE**

### **6.2.1. METHODOLOGY**

The evidence was collected in the period August 1997-June 1998. Because I was not affiliated with any institute in the city, it was difficult as a private researcher to gain access to the interviewees. In view of limited resources and the practical difficulties of interviewing businessmen in Russia, who are usually reluctant to speak about their business to outsiders and often try to attract as little attention as possible, it was decided to interview representatives of Russian and foreign organisations dealing with small businesses. During my several trips to St. Petersburg I met representatives of fifteen organisations, which included half of the foreign organisations working in St. Petersburg and some of the Russian ones. Each of the interviewee filled in a questionnaire which took at least two hours to complete. In a first interview I explained the aims of the questionnaire and tried to get some information on the selection process and on the firms they were working with. I asked them to respond to as many questions as they could, leaving out those which in their opinion would have required too much time to answer. The questionnaire was left in their hands so they could refer to their own sources to obtain data which were not readily at hand. In fact, it may be a painstaking work to trace data on the firms with

which they worked. It involves going through the files where the application for loans are kept. For this reason not all the questions were answered. After I had collected the questionnaire, I would again contact the representative to clarify the answers which were not clear to me. Unfortunately not all organisations which initially promised to fill in the questionnaire did so. Some could not be contacted again after a first visit, or explained afterwards that the information I require is confidential and cannot be divulged to third parties. In the end seven replies were received, which is not a great number, but the total number of firms they refer to is substantial. One gave answers on the basis of just three firms, but Karasev of TUSRIF provided data on 328 firms. In total the seven organisations provided data on 624 firms. The representatives who filled in the questionnaire were:

- I. Karasev, vice-president of the U.S. Russia Investment Fund (TUSRIF) (partly funded by USAID)
- N. Ramsden, loan co-ordinator of the South Shore Bank working on a EBRD contract to finance small businesses
- K. Carlton, deputy director of the Innovation Centre for the production of clothes (funded by USAID)
- E. Danishevskaja, loan co-ordinator of the Center for Citizen Initiatives (funded by USAID)
- V.F. Tul'vert, "main specialist" of the Innovation-Marketing Centre of the State Fund for the Development of Small Business in St. Petersburg
- S.A. Siling, general director of the Fund for the Development of Science, Technology and Franchising (a state organisation)
- A. Nekludov, deputy executive director of Rusnord (a non-profit organization, established by the Nordic Council of Ministers, the St. Petersburg Government, and other partners to support small business and assist Scandinavian businesses in Russia).

The questionnaire is divided into six sections. The first part consists of questions relating to the characteristics of the firms, their origin, the year of creation and who the owners are. The second part consists of two questions

about the entrepreneurs, while the third part seeks to assess how small firms are performing, their market, their capacity to invest, their turnover trend, the purchases and the degree of competition they face. The last three sections are qualitative, comprising open questions on the business environment, on the policy towards small enterprises and a question relating to any other general comments that the interviewee would like to make. As one reply alone accounts for 53% of the total number of firms, the size of the sample for each question is heavily dependent on that reply.

The evidence collected is not an accurate picture of small business in St. Petersburg, as the firms covered are not a fully representative sample of the small business population in St. Petersburg for two reasons: a bias towards successful firms and a sectoral bias. Most of the replies of the representatives do not contain an obvious bias, as firms covered are the ones which were not excluded after a first screening. Firms were excluded after a first screening because they could not technically be considered for financing, either because it was not clear how they were using the finance, or because the business plan was not well-made, but not because they were not performing well. However, it can be presumed that the better performing firms may be more likely to apply for a loan than those whose performance is sub par, as the latter might think that the possibility of receiving a loan would be highly unlikely. Some replies, instead, refer only to firms which actually received the financing, but these account for less than one-third of the sample. There is also a sectoral bias, as firms which work mainly on a cash basis such as restaurants are not taken into consideration, since the official revenues can be just a fraction of the real ones; and there are no scientific firms since these tend to apply to the specialised funds<sup>17</sup>. The evidence collected is biased towards manufacturing firms. In general, slightly over half of the total are manufacturing firms as the term “others” includes mainly service firms (see question no. 7 on page 309). As a comparison, in St. Petersburg industrial firms accounted for 16.5% of the total number in 1997. Only registered enterprises are taken into

consideration by these organisations. Joint-ventures are absent, apart from a few covered by the TUSRIF reply, as they are not eligible for loans from the these organisations.

### **6.2.2. GENERAL FEATURES OF THE FIRMS**

There is a marked preponderance of new firms - also referred to as new start-ups - (94%) over privatised units (1% of the total) and former co-operatives (5%). The question of how many firms are spin-offs from larger enterprises was not answered by the two respondents giving data on the largest numbers of firms. For this reason the sample is smaller on this question. On the basis of data relating only to these answers 13% of the firms are spin-offs from larger units, but taking into account that spin-offs are mainly created from industrial firms we can say that approximately one-quarter of small industrial firms have this origin and, therefore, considering new firms represent 94% of the total number, almost all the others must have been set up from scratch<sup>18</sup>. Almost half the total number of firms were created in 1996-7 and only 7% in the communist period before 1992. However, excluding the innovation centre which is geared towards helping recently created firms, the foundation rate is more evenly distributed: firms set up in the years 1994-1995 and 1996-1997 each account for approximately a third of the total and firms founded in 1992-1993 for a quarter. This suggests that the rate of creation of new firms has been rather uniform in the post-communist period. Official small business statistics for St. Petersburg indicate a more consistent increase in total units in 1994 and 1996, and a consistent growth in absolute numbers in the other years; so the results concerning these firms roughly correlate with the official figures.

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<sup>17</sup> Scientific firms made up 5% of the total number of firms in 1998, so their exclusion does not modify the picture substantially.

<sup>18</sup> It might be that all industrial firms are new firms, or that all former co-operative/leasehold and former state/municipal firms belong to the industrial sector, instead of the service sector, but the result would not be very different, as the latter categories account for only 6% of the total number of firms.

Three legal entities are predominant in the sample: closed joint-stock companies, almost half the sample, and private individuals and limited liability firms, which account for a quarter of the total each. Slightly more than half the firms turn out finished products. Most of the industrial firms are involved in light manufacturing activities, which do not require high initial capital, such as dressmaking, food processing, printing/publishing and consumer goods production. Construction and building materials are under-represented, despite the boom in residential construction taking place in Russia. As 75% of the firms are engaged in trade and services, approximately half the industrial firms must also be active in this area. Diversification is often a means of survival given the poor profitability of manufacturing activities in Russia. Given their short period of existence, these firms are still quite small. Just 15% have more than fifty employees and 35% have fewer than ten. The answer regarding the turnover was answered only by the two USAID-funded organisations, which tend to work with micro enterprises, and by the representatives of the South Shore Bank and Rusnord. On the basis of their answers we have an average annual turnover per employee of \$8,600<sup>19</sup> which, although very low compared with Western Europe, is not far from the analogous figure regarding small businesses in Russia as a whole, whose average turnover per employee in 1997 was about \$6,000 (Russian SME Resource Centre, 1998a: 4). It must be borne in mind that small businesses in Russia tend to underreport their sales heavily as a tax-avoidance tactic.

Almost half the enterprises on which information is available are owned by the manager and another half by other private local investors, a possible sign that people who have become rich in the early transition years, presumably through trade, are now also investing in production. There are no firms set up by investors from other regions and by workers' collectives. The average age of the entrepreneurs is thirty-eight. The most entrepreneurial age group is 30-39, which contribute half of the cases,

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<sup>19</sup> This is calculated by taking the median figure for each of the bands in the answers to the questions relating to turnover and the number of employees, and calculating a weighted

followed by the 40-49 age group accounting for a quarter. Just 11% of the entrepreneurs are over fifty years old. The contribution of the 20-29 age group is also small. A similar picture emerges from surveys carried out in Russia and other East European countries (Erutku and Vallee, 1997: 114), even if in some surveys the 40-49 age group comes first and the 30-39 age group second<sup>20</sup>. Among the older generations the idea of being engaged in entrepreneurial activity is to a large degree alien to their mentality, having lived for most of their life under a communist system, while the younger generation (20-29) is less inclined to set up a firm, as at that age one usually lacks the experience and capital to start a venture. The high proportion of women entrepreneurs (34%) is due to the fact that the innovation centre accepts only women and the Center for Citizen Initiatives by statute must give most loans to women. Disregarding the replies from these two organisations, the proportion of female entrepreneurs falls to 19%, somewhere in between the share detected by Webster and Charap in 1992 (1994: 1) and the one detected by Zhuplev, Kon'kov and Kiesner (1998: 509) in a survey carried out between 1994 and 1997.

### **6.2.3. PERFORMANCE, SALES, EXPORTS AND PURCHASES**

The great majority of these firms are profitable, as would be expected, the majority having qualified to receive a loan. Just 4% are loss-making and 7% break-even. I have included a similar question to this concerning the financial situation of the firms to check the accuracy of the answers on these points. Comparing the replies to these two questions, it appears that in some replies the percentages of firms in "bad" conditions and "close to bankruptcy" is higher than that of firms incurring losses. Not all the firms which were held to be profitable fall into the "good" and "satisfactory"

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mean. Only data from those organisations which supplied answers to both questions were used in the calculations.

<sup>20</sup> Ivantsova (1998: 8) in a survey of small industrial firms in the Nizhegorodki region, found that 49% of the entrepreneurs were aged between thirty-nine and forty-eight years, 22% between twenty-nine and thirty-eight and 23% between forty-nine and fifty-eight. This was, however a small-scale survey based on only fifty-seven firms. Andreeva, Vasilenko and Raskutina (1997: 51) found the following percentages: aged 41-50: almost 40%; aged 31-40: 30%; aged over 50: 13%; aged under 30: 12%.

economic condition, but some fall into the “bad” and “close to bankruptcy” categories<sup>21</sup>. Firms breaking-even were also associated with different economic conditions such as “satisfactory” or “bad”. Overall, however, the share of firms “close to bankruptcy” corresponded to the share incurring losses and the share in a “bad” condition to the share of firms breaking-even. Therefore, the share of companies in a “good” and “satisfactory” condition was the same as that of the firms generating profits. Among profitable firms three-fifths are in a “good” economic situation, while two-fifths are “satisfactory”. The figures on these two questions are quite consistent with Richter and Schaffer’s (1996: 10) results on new start-ups (the share of loss-makers in their sample was 11%) and not far away from those detected in a survey conducted by the Leontief Center (1999: 12) on small business in St. Petersburg in 1999<sup>22</sup>(given the strong increase in the number of small businesses in the city the great majority of these are start-ups). The share of firms in an “unsatisfactory” condition is instead much higher in other surveys including all kind of firms, not just start-ups<sup>23</sup> (Glisin and Rogachevskaia, 1998: 28; Blinov and Nikitov, 1995: 46). Also, on a national basis there is a discrepancy between the number of profitable firms and the number of firms which, according to surveys, are in a “good” or “satisfactory” condition. On a Russia-wide basis, according to a survey of the Russian Economic Barometer, only about 20% of the industrial firms described themselves as in “good” or “normal” condition in 1997, with a peak of almost 30% in October (Russian Economic Trends, May 1999: 6), while loss-makers accounted for 47.2% in large and medium enterprises and for 21.6% in small firms in that year (Russian SME Resource Centre, 1998b: 4). Evidently a substantial proportion of firms making profits or breaking-even do not define themselves as being in a “good” or “normal”

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<sup>21</sup> For example, Danishevskaja affirms that all forty firms generate profits, but when asked to describe their financial situation she indicates that one is “close to bankruptcy” and two are in a “bad” condition.

<sup>22</sup> In this survey the share of firms in a “critical” condition was 6% and that of firms in an “unsatisfactory” condition 19%.

<sup>23</sup> According to the survey conducted by IPSSA between 1992 and 1994, mentioned in chapter three, no difference in the economic situation was, instead, detected between new firms and privatised ones. However, this might be due to the fact that the years immediately after the communist downfall are considered to have been easier due to the limited competition.

economic condition. Perhaps due to the fact that not all expenses can be deducted in full, a profitable balance sheet may hide a difficult situation when all the costs are considered.

The turnover trend is very positive. Three-quarters registered an increase and only 13% a decrease. Twenty-six per cent of the firms had a growth of between 50% and 100% and 44% an increase of up to 50%. Considering that these companies are very young it is, however, disappointing that just 5% managed to double the turnover of the previous year. It is interesting that firms covered in this study sell mainly to private counterparts, which might be one of the reasons why they perform well. A survey of small industrial firms carried out in 1997 in another region found firms registering turnover increases accounting for less than 20% of the sample, while for half it was stationary and 26% had a decrease (Glisin and Rogachevskaja, 1998: 25). The large difference among the findings of this survey and my study could be a sign that the group of firms covered in this study are not really representative of the small business sector, but the reason may also lie in the different proportions of new start-ups in the different studies<sup>24</sup>, as surveys of new firms also detected a positive output trend, although these surveys refer to a few years earlier. Richter and Schaffer (1996: 8) detected a positive, although modest, output trend among the new start-ups included in a World Bank survey, whose cumulative turnover increase was 4%, while a study reported by the European Bank for Reconstruction and Development indicated an increase in real sales of 17% in start-ups (EBRD, 1998a: 142).

The companies covered in this study import much more than they export. There is, however, a large discrepancy in the replies obtained. TUSRIF-covered firms (half of the total) make 65% of their purchases outside the former Soviet Republics, while firms funded by the South Shore Bank

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<sup>24</sup> The proportion of start-ups in the Glisin and Rogachevskaja sample (1998: 25) is not clear. They indicate that 30% are privatised firms and that more than 50% were formed through other methods such as the creation of new firms from scratch, or the purchase of an existing firm or of a part of an existing firm. The remaining were formed through other additional methods.

funded make just 20% of their purchases from outside these countries and 70% from the local market. The other answers also give differing results, some similar to TUSRIF and others to the South Shore Bank. As far as sales are concerned, data provided by four respondents (42% of the firms covered) indicated that the market of these firms is largely confined to the city of St. Petersburg, while firms covered by TUSRIF have a much wider market, selling two-thirds of their output in other Russian regions. The reason for this marked difference is not clear. There is, however, a practical unanimity on the fact that the amount of exports is limited, accounting for between zero and 10% of the total turnover of the firms covered by each organisation. Only 0.2% of the firms export more than half their production and a further 0.5% export between 30% and 50%, while 96% do not export anything. The average for the 328 firms covered by TUSRIF is 5%. The only dissenting voice, which gives a figure of 45%, provides data on only three firms. Assuming that the average turnover of the total number of firms<sup>25</sup> each organisation dealt with is the same, around 41% of the sales are in St. Petersburg, 54.5% in the other Russian regions and just 4.5% abroad<sup>26</sup>. However this is a guess, rather than an accurate measure. No much progress seems to have been achieved since 1992 - when exports were found to account for 3% of the turnover of the small businesses surveyed (Webster and Charap, 1993: 4). A weakness of small enterprises, not only in St. Petersburg, but in the whole of Russia, is the limitation of their outlet market, as also shown in other surveys (Zhuplev, Kon'kov and Kiesner, 1998: 508). Small firms in Moscow sold 83% of their output locally in 1998 (Alimova: 1) and similar percentages were indicated by surveys carried out in other Russian regions<sup>27</sup> as well as in Bulgaria (Bartlett and Rangelova, 1998: 240) and Poland (Kondratowicz, Maciejewski and Morawski, 1997:

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<sup>25</sup> The figures on turnover were provided just by three respondents.

<sup>26</sup> These percentages are calculated using a weighted average of the figures in the answers to question twenty-four, considering the number of firms each answer refers to. The two USAID-funded organisations dealing primarily with micro enterprises were excluded. A distinction cannot be made between the turnover sold in North-West Russia and other parts of Russia, as Karasev lumped together the figure for North-West Russia and the other Russian regions.

<sup>27</sup> In the Nizhegorodki region the small industrial firms surveyed sold 74% of their output in the home region, 20% in the other Russian regions and 6% abroad (Ivantsova, 1998: 9).

147). The remaining output of the Moscow-based firms was sold mostly in the nearby regions (5.9%) and other Russian regions (8.1%). Just 3% was sold abroad. Moscow differs from St. Petersburg in the lower propensity to make purchases abroad: 87% of the purchases made by Moscow's small firms were made in Russia. This is likely to be due to the greater distance of Moscow from the border. On the other hand, the proximity of St. Petersburg to foreign markets does not result in a higher level of exports. Are the goods turned out by these companies of such low quality that they cannot have a market abroad? In surveys, when entrepreneurs were asked to evaluate the competitive capability of their firm, fewer than 10% thought it was "high" (Glisin and Rogacievskaja, 1998: 27). According to some of the representatives of the organisations interviewed in St. Petersburg, the main obstacle to exporting is the weakness of marketing skills, while there are divergent opinions on the quality of the firms' products in relation to Western ones. Karasev, who has examined the largest number of firms, judges it to be lower, as do two other respondents, while two are of the opinion that small businesses suffer from an image problem and that quality is, in fact, higher than Western perceptions. Another hurdle to exporting indicated by several respondents is the complicated customs formalities. The most utilised methods of gaining information on foreign markets are personal contacts, the Internet and literature such as price lists and magazines, while no mention is made of business organisations such as chambers of commerce.

Overdue payment from customers, especially from state enterprises, continues to be a pressing issue, which, according to the representatives of the organisations interviewed, affects not only large enterprises, but also smaller ones. It is therefore surprising that, according to TUSRIF, only 20% of firms require prepayment.

Competition is growing, in the opinion of almost all the respondents. The share of firms with no competitors is 3%. An higher share is indicated by a Leontief Center survey - 9% (Leontief Center, 1999: 13). Even taking into

consideration this latter share there is, nevertheless, a marked difference with 1992 when the corresponding share was one-third (Webster and Charap, 1993: 46). For a comparison, in Moscow it was 5.1% in 1998 (Alimova, 1). Half of the firms in this study have as their main competitor a small private firm. The large share represented by these firms is to be expected as private firms tend to occupy new niches created by the transformation process and also in surveys on other countries private firms were found to be the strongest competitors of other private companies (Arendarski, Mroczkowski and Sood, 1994: 48). The number of main competitors represented by foreign-owned organisations is quite substantial (17%), as well as that represented by state firms (22%), while the small presence of large private firms among the list of competitors is puzzling, - just 8% - despite the fact that most large enterprises have been privatised. It is recognised that in Russia the impact of privatisation has been weaker than in other transition countries and it is even debatable whether it has had a positive effect at all. As far as St. Petersburg is concerned, Jones (1998: 94-5) found positive effects only for bank-owned enterprises, but, from the results listed above, privatisation would seem to have had an adverse impact.

### **6.3. CONCLUSION**

The business environment in St. Petersburg does not seem to differ from the rest of Russia (except perhaps Moscow), despite it being considered the most westernised city in the country. While the corruption of local bodies is ranked by entrepreneurs among the major hindrances to their activity, crime does not seem to represent a major problem for small businesses in St. Petersburg. The success of a business is connected to a variety of factors which make the business environment unpredictable (bank closure with loss of assets, tax inspections with a predatory attitude, lack of payment even by the state, disappearance of market niches).

This chapter has focused in particular on manufacturing, which in Russia is penalised by the more complicated procedure for setting up a firm in this sector, by having more supervisory bodies, and therefore being more vulnerable to inspections and subjected to a greater number of taxes. Despite this, local industries are making significant inroads in some sectors of the economy, increasing their market share at the expense of foreign firms. The majority of the firms covered in the interviews remain, however, in a very precarious financial position. They do not generate enough circulating capital to make any investment and have to utilise old and outdated equipment. Firms tend to have a very flexible employment structure as demand is not stable. Staff is usually reduced to a minimum, usually just administrative personnel, while industrial workers are employed only where there is an order. Alternatively, the work is contracted out to a larger factory where, usually, the problem is the converse: a surplus of workers. From these interviews it seems that the better-performing firms are those selling directly to consumers or retail outlets, while those selling to industries or budget-financed institutions have great difficulties surviving. It must, however, be said that this is not always the case, as firms producing intermediate inputs account for almost half of the of the firms covered by the questionnaire, which are largely in a sound financial condition and expanding production, although from a very low turnover. The results on the output trend and profitability of these firms - mostly newly set up firms - do not differ substantially from those of surveys carried out on this kind of firms. However, these firms' representativeness of the new private sector needs to be confirmed by further surveys on the subject, as the evidence available on newly created firms is very limited. Nevertheless, despite question marks over the representativeness of this group of firms, the data provided can give some useful information on the small business sector in St. Petersburg. The fact that half the firms have as their main competitor another small firm testifies to the greater adaptability and flexibility of new firms compared with larger ones. The former have proved much more successful in filling the niches created by the transformation process. They have, however, to have a very local outlook: almost all founders are from

the city and their sales are almost all domestic. Export-led growth does not seem an option for these companies, even if the low level of domestic demand acts as a severe constraint to business development. There is more diversity in the purchases, as many inputs are not produced locally.

Following this description of the general outlook of small business in St. Petersburg the next chapter analyses the contribution of the local science parks and innovation centres in fostering technology-based entrepreneurship, together with the measures implemented at national and local level to further the same aim.

## 7. SCIENCE PARKS

### INTRODUCTION

We now turn the attention to examining the closely related chapter concerning the development, organisation and functioning of science parks within the context of the development of small business. Given the importance of the science sector in the local economy it was deemed necessary to dedicate a separate chapter to the development of scientific entrepreneurship and science parks. The realisation of the commercial potential of this sector was expected to be one of the major assets of the Russian Federation. It was believed that there was an unexploited scientific talent which had so far been stifled by the planned system, but that could now be realised in earnest. Considering the technological backwardness of the country, entrepreneurship in technology-based products should be vital for Russia in narrowing the gap with the most advanced nations. In St. Petersburg, given the abundance of scientific skills, this was expected to be one of the main avenues of development in the transition to the market economy. The degree to which these expectations have been realised is discussed in the chapter. One of the main means of stimulating technology-based firms is the creation of science parks whose role in this context is discussed along with their various definitions. The change in the role of the Russian state in relation to R&D is also considered along with the development of science parks in Russia as a whole. A separate section deals with the local innovation policy in St. Petersburg. The creation of science parks has been one of the few measures utilised in Russia to foster scientific entrepreneurship, as science has ranked at the bottom of the list of priorities of the government. Science parks have been criticised by some authors regarding their success in nurturing businesses, as no significant difference was found between the closure rates or growth of high-tech firms based in science parks when compared with those based outside them (Storey and Westhead, 1994: 29). However, in Russia their contribution is essential. The establishment of science parks was a response to the need to overcome

the lack of experience in world-wide technological co-operation and competition, and the lack of skills in marketing, design and financial management in order to assist would-be entrepreneurs in the technological sphere. As an example to analyse how science firms have fared, the performance of the science firms located in these structures is examined, and the nature and effectiveness of contribution of science parks and innovation centres in St. Petersburg to the creation and development of small technology-based firms is assessed.

### **7.1. THE ROLE OF SCIENCE PARKS IN THE PROMOTION OF INNOVATION**

The last two decades have witnessed a change in R&D policies. While in the 1970s the norm was to support single technology-based projects, from the 1980s onwards support has been increasingly directed towards the dissemination and utilisation of knowledge rather than towards single projects. The rationale of the previous policy is that without such financial support firms would underinvest in innovative activities, as they would be unable to appropriate all the benefits arising from these. However, its weakness lies in the difficulty in assessing how much of the state funding received by a company represents additional expenditure rather than a substitution for expenditure which would have been made in any case. In the last two decades support has been targeted mainly at sponsoring inter-firm and academic-industrial collaborative programmes, while financing single innovation projects has remained a policy option only on behalf of small innovative enterprises in the early development stage through, for example, the creation of specialised venture funds. While in the past innovation was seen as an in-house linear process, now innovation is perceived in terms of the interaction and dialogue between the various players (universities, businesses, individuals and public institutions). This should create a catalyst effect. It has been verified that the rich and varied interaction with the different partners, be they other firms, research centres, consulting services or other organisations allow firms to develop a

competitive advantage. Science parks have been one of the means to carry out this new strategy in R&D policies. As small firms are less experienced in collaborating with the other players, R&D policies have been directed at encouraging this collaboration through, among other things, the formation of science parks. The idea upon which science parks are based is that the proximity with other firms, research centres, consulting services and other organisations should provide a fertile environment for the development of technology-based firms.

The number of science parks has multiplied from the eighties onwards not only in Western Europe, but also in less developed countries and, after the end of communist rule, in the former socialist bloc. There is not a single definition of the term science park and similar terms like “Research Park”, “Technology Park”, “Business Park”, “Innovation Centre” are used to indicate similar developments. Macdonald (1987: 25) purported that these terms could be used interchangeably as long as they meant property-based initiatives close to a place of learning with high quality units in a pleasant environment. However, they often take different connotations depending on the interpretation of their functions. Currie (1985: 1-2) defined an innovation centre as a structure catering for new firms at the initial phase of development with subsequent exit once they have grown, while science parks accommodate both start-ups and medium-sized businesses and provide also small-scale manufacturing. In his interpretation research parks differ from science parks because the only manufacturing activity allowed is the production of prototypes.

In accordance with the definitions used in the EU programme SPRINT (Malara and Tosi, 1993: 120-122) these structures can be divided into 6 categories:

- research parks are closely linked with universities or research centres and are involved mainly in research rather than development. Their main feature is the undertaking of leading-edge research in collaboration with universities.

- science parks are situated close to universities or research centres. Their aim is to promote the creation and the development of technology-based firms and to promote technology transfer from universities and research institutes to the firms located in the park. They are involved in R&D up to the stage of commercialisation. Their activity is restricted to the development of prototypes, while production takes place outside the park. Limited production can exceptionally take place for high-technology products.
- technology parks include a wider sphere of activities: R&D, production and sale. They are not necessarily linked to universities, but are often set up in the proximity of big high-technology firms.
- innovation centres are aimed at assisting enterprises, especially new ones, in the development and commercialisation of new products and new technological processes. This is done not only through the provision of managerial assistance, but also by putting them into contact with a regional network of financial institutions, consulting firms and research centres. Consulting is provided regarding possible sources of finance, marketing and technology transfer. The emphasis is on high-technology firms.
- business incubators are structures which cater for new enterprises regardless of whether or not they are technology-based. The aim is to increase their chances of survival by offering managerial support, advisory assistance and common services (fax, computers). The evidence from several studies points out that approximately 70% of the new enterprises which fail do so because of a lack of relevant management expertise (D' Andrea Tyson, Petrin and Rogers, 1994: 179).
- commercial/business parks offer a wide range of activities in a high-quality setting: production, assembling and sales. They do not presuppose a link with universities. Some technology parks which have not been able to attract enough high-technology firms have become commercial parks.

Summing up, at one extreme are research parks accommodating mainly R&D companies of multinational organisations which want to be near a centre of excellence in research represented by the university, and at the other are science parks, technology parks and innovation centres which are expected to bring economic benefits to the local region. The same aim is entrusted to business incubators and commercial parks, but the profile of activity is broader than just technology-based firms<sup>1</sup>.

## **7.2. STATE POLICY TOWARDS SCIENCE IN RUSSIA**

The Soviet Union had 1.5 million researchers and technicians working in R&D in the late 1980s, almost a quarter of the world total. Approximately 70% of research is thought to have been oriented towards military purposes. On a sectoral level R&D expenditures in Soviet times were strongly biased towards the engineering sector, which accounted for three-quarters of total expenditures, considerably more than in market economies (Gokhberg and Peck, 1997: 97). Two-thirds of R&D plants and personnel were concentrated in Russia. Although they reached a level of excellence in several fields, the dissemination of new products and techniques was very limited, at least in the civilian field. In Soviet times science institutes tried to fulfil the requests coming from the ministries and no real links existed between R&D organisations and enterprises with the result that R&D had little effect on production.

After the fall of the Soviet Union the low priority accorded by the Russian government to science led to a considerable fall in R&D levels and in the number of research workers (approximately by 50%) between 1990 and 1994 (Gokhberg and Peck, 1997: 96). In 1992 alone the miserable salaries pushed 25% of the science and research community to take up jobs in the private sector or abroad (Burtseva and Motova, 1996: VII). This loss has

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<sup>1</sup> How to define high technology is not easy. Usually the indicators are the level of R&D activity and the proportion of scientific, engineering and technical employment in the company. As a rule, high technology industries are defined as industries in which the ratio of R&D expenditures to sales is at least twice the average of all industries, and/or the relative employment of technology oriented workers is treble the rate of all industries

been particularly significant in fundamental science (mathematics, biology, theoretical physics) where the loss of state support can hardly be replaced with private sources. Budget allocations for science fell from 2.03% of GDP in 1990 to 1.23% in 1997, but were as low as 0.82% in 1994 (Matveev, 1998: 1). Real financing has, instead, been much less, falling from 0.69% in 1992 to 0.52% in 1993, 0.44% in 1994 and 0.29% in 1995 (Dezhina, 1996: 78). Considering that GDP has halved in this period, science funding has been reduced almost ten times between 1990 and 1997. The decrease in budget financing has obliged research institutes to find other means of support, as basically government support covers only wages, overheads and operating expenses. Many research institutes manage to survive only by renting out a portion of their premises to private businesses, and by allowing their researchers to have two jobs, as the average salary of the research workers dropped below the Russian average<sup>2</sup>. In 1995, 51% of the research institutes were leasing part if not all of their premises (Gokhberg and Peck, 1997: 97). Despite this, the state continued to be in the mid-1990s the main source of financing for more than 90% of Russian R&D institutes (Dezhina, 1996: 79). Meanwhile, R&D material and technical equipment is deteriorating because obsolete equipment is not being replaced. All these factors, of course, have had a detrimental effect on research. Especially in institutes requiring large quantities of equipment and materials, research has come to a standstill.

In the Soviet Union scientific research was conducted in four sectors: branch research institutes, the Academy of Sciences, enterprises and universities and technical institutes. Branch research institutes included both defence and civil R&D organisations. These accounted for over 70% of the R&D workforce, while the Academy of Sciences accounted for 12%, enterprises for 10% and university for 6%. Branch research institutes working for the defence sector and the institutes of the Academy of Sciences received the largest amount of financing and attracted the best

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(Aldrich and Von Glinow, 1992: 235).

<sup>2</sup> In St. Petersburg it was 72% of the average salary in 1996 (The Socio-Economic Situation In Saint Petersburg. A General Overview, 1997, no. 29: 10).

researchers, but the former have fared worst following the collapse of the command system and have lost the greatest share of researchers. Eighty-one per cent of the researchers who left this sector had worked for branch research institutes (Gokhberg and Peck, 1997: 97). The Academy of Sciences has fared relatively better being able to retain an higher share of its budget allocation and having had only a limited outflow of researchers.

The switch to the market has entailed a new role for the state and the setting of a legislative framework. A number of laws were approved in 1992 to guarantee the legal protection of research findings. In general the Russian government has made considerable progress in constructing a legal framework to bring Russia up to world standards in the area of intellectual property protection, but the enforcement structure (inspection, penalties for fraud and infringement) is still weak.

As a rule, innovation policies pursued by governments can be broadly divided into three categories:

- provision of finance for innovation which can take the form of direct support through grants or loans for individual projects, and indirect support through fiscal concessions for R&D or other technology-based activities.
- support for networking in order to improve the collaboration between firms and public sector laboratories and universities.
- provision of advice, information and infrastructure through, for example, the creation of business centres specialising in the provision of technological services to small and medium enterprises.

With regard to the first point in Russia, a new system for the financial support of science was created in the post-communist period. This is based on a plurality of sources of financing, the choice of projects on a competition basis with the assistance of independent experts, and the introduction of a contract system for the realisation of state orders. Tax concessions and other privileges aimed at the promotion of innovation in

industry have been introduced by the federal programme for 1997-2000 “Research and Development in the Priority Sectors of Development of Science and Technology”, as before there was not any kind of privilege for R&D. The last two policies have been carried out only piecemeal, and only in the last few years following the implementation of the programme “Promotion of Innovation”, approved in 1997, which will be discussed later.

Barring bank loans which are very difficult to obtain, small technology-based firms can receive financing, without having to provide guarantees, from the Programme of the Higher Institutes of Education for the Support of Entrepreneurship and New Economic Structures in Science and Scientific, from the Russian Fund for Technological Development, from the State Fund for the Support and Development of Small Business in the Scientific and Technological Sphere (henceforth State Fund) and from a number of funds financed by foreign sponsors. The first programme will not be described, as it has very few resources, while the two state funds created to finance innovation are discussed in the following paragraphs. Each of them finance different stages of development of high-technology products and processes. However, the total financing provided by these funds has not been very large, when compared to the size of the Russian economy.

The Russian Fund for Technological Development was established in 1992 by the Ministry of Scientific and Technological Policy to finance technological projects at the final stage of their development before they move on to the manufacturing stage. It provides 2½ to four years loans of between \$100,000 and \$300,000, mainly in hard currency, with no interest charges.

The State Fund was founded in February 1994 by the State Committee for Science and Technology in accordance with a government resolution carried on February 3, 1994. It is financed mainly from the state budget at

the level of 1% of the state's allocations for science (0.5% before 1996). Eighty per cent of the resources of the Fund are spent in granting loans and leasing for a maximum amount of about \$100,000. The interest on these loans is 30-50% of the Central Bank rate. Only projects which involve new products/services or new technology used for manufacturing are considered. Financing is given on a competitive basis, mostly to buy technological equipment. Preference is given to firms which are already producing or intend to move from the production of prototypes to serial production. In 1995, for example, the Fund evaluated 1,500 projects, of which it financed 300 (IPSSA, 1997b: 44). About 700 leading scientists take part in assessments of the projects which are carried out every three months. In 1995-96, 70% of finance provided was repaid, which the fund considers to be a good achievement taking into account the high level of risk in these ventures (IPSSA, 1997b: 44). The remaining resources went to finance the following activities in the first three years of the Fund's existence (Begidzhanov, 1997: 23):

- creation of a network of innovation centres, 9% of the Fund's budget
- support of consulting/training activity, 3.5% of the Fund's budget
- financing of research, 2% of the Fund's budget.

### **7.3. THE DEVELOPMENT OF SCIENCE PARKS IN RUSSIA**

In Russia the concept of science park was introduced in 1988 following the publication of an article in a Russian scientific magazine. The first science park (referred to as technopark in the Russian context<sup>3</sup>) was established in Tomsk in 1990 jointly by universities, scientific institutions and industrial enterprises, some of which had to undergo conversion. In Russia most of the technoparks have been set up under the state programme "Technoparks and Innovations" which aims to promote the scientific potential of the institutes of higher education. The number of Russian technoparks created in the framework of this programme was fifty-two out of sixty-two in

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<sup>3</sup> The term technopark is utilised to distinguish it from an innovation centre. The term science park will be subsequently utilised in the Russian context to indicate both technoparks and innovation centres.

January 1996 and the number of small firms based in these structures more than 1,000 (Kudinov, 1996: 16; Lur'e, 1997: 36). This was the first state programme for the creation of technoparks, but very few resources were allocated. For this reason just a minority of technoparks have reached an advanced stage of development. By the beginning of 1998 the number of university technoparks had risen to sixty-two. Seven are considered to be the technopark leaders, comparable to Western technoparks; fifteen are in the process of catching up, while the others remain at a more elementary level. Fourteen of these technoparks were founded in 1997 and are now at the stage of incubation. In 1998, five more were in the process of being set up, while a further seven are planned before the year 2000.

Most of the innovation centres and technoparks in Russia are non-profit making organisations which, according to the statute, must reinvest any profits to develop its infrastructure and the services to tenant companies, but their financial situation is not easy given the low demand for technology-based products<sup>4</sup> in Russia and the difficulties in attracting private investors. The vast majority are members of the national association Business Incubators and Science Parks Association (BISPA) which in the framework of international and domestic programmes has organised training courses for more than 200 technopark managers up to 1997. A unusual feature of Russian technoparks is that the vast majority of them have originated from institutes of higher education, despite that fact that universities accounted for only 6% of R&D personnel in the Soviet Union, while branch research institutes, where the bulk of R&D personnel was concentrated, have participated very little. This is because the latter has suffered much more from the disintegration of the command system. For example, in St. Petersburg the sixty-six project bureaux that existed in 1990 employed 27,200 people; by mid-1995 there were only fourteen with a total number of 929 employees (Davidiuk, 1996: 18).

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<sup>4</sup> The highly technology-based industrial sectors are those which have fared worse since the switch to the market economy.

One peculiarity of Russian technoparks is that not all firms are accommodated on site due to space limitations. Some are located in the nearby university or in other institutions linked to the technopark. Actually very few firms ever leave the technoparks. This is true also for the older technoparks set up at the beginning of the nineties. According to a survey carried out by the Free University of Berlin (Pfirmann, 1998), only seven technoparks out of the eighteen surveyed replied that one or more firms had left to settle elsewhere<sup>5</sup>. In Russia technoparks are usually dependent on other institutions, mainly universities. As a rule, the university provides the building and finances most of its current expenses, while the state usually finances the purchase of some equipment and the reconstruction of the building. Annually the state programme provides support to the existing technoparks, but this is rather meagre. In 1997 universities provided more half of the total financing, whereas the state, including state funds, provided less than 10%. Local bodies and financial institutions have not been very generous either (Lur'e, 1998). St. Petersburg will represent an exception if its programme for the development of entrepreneurship is approved by the municipal assembly.

According to an appraisal of the Russian technoparks conducted in 1997 (Shukshunov and Variukha, 1997: 35) the main features of these structures are:

- the number of founders ranges from three to twenty-one. Fifty per cent have more than ten founders. These founders are mainly large enterprises, universities and local administrations.
- 93% are individual companies, while the remaining 7% are subdivisions of universities.
- the average number of firms accommodated is twenty.
- the great majority collaborate regularly with scientific centres, universities, industrial enterprises, regional and local authorities.
- 15% own the premises where they are located, while the others rent these from the founders on advantageous terms, often free of charge.

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<sup>5</sup> Survey presented at the III international congress "High technology. Innovations.

- all provide office premises and about 60% also provide industrial premises.
- 65% offer management assistance in finance, marketing and business organisation.
- almost half do not provide assistance for technology transfer and 60% do not provide advice in financial management.
- 44% have also a business incubator, but none has a special building where the incubator is located.
- the most developed technoparks - 20% - have premises specially built to satisfy the requirements of the tenants.
- only 24% claim to have had an impact on the socio-economic and technological development of the region.

The picture of Russian science parks is, therefore, one of institutions which are undercapitalised with few if any assets and with a limited economic impact locally. Regarding the services provided, according to the director of the technopark of the Moscow State University (Rychev, 1998: 74) tenant firms appreciate most the provision of consulting services, such as the drawing up of business plans, marketing, joint participation at exhibitions, while much less interest is shown in the provision of services such as leasing of computer and office equipment and rental of premises (conference rooms).

In addition to science parks and innovation centres at the beginning of 1996 there were more than forty business incubators in Russia (CCET, 1998: 76), a number which increased to fifty-eight by 1998 (Sokolovskaia, 1998a: V). Some of these incubators are created on the basis of technoparks and form part of them while others are independent. Sixteen business incubators reserved for young entrepreneurs had been funded by the State Committee for Young People, and fourteen business incubators (as of mid-1997) were set up in the framework of the Morozov project. At that date the latter accommodated eighty-eight firms which employed a total of 758 workers.

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Investments -- 98" which took place in June 1998 in St.Petersburg.

They provide the standard services offered by business incubators around the world: space that can be leased at a reasonable price and shared business services such as computers, fax machines and consulting. The Morozov project which is jointly financed by the United States Agency for International Development (USAID) and by the European Bank for Reconstruction and Development (EBRD) includes also a wide network of management training centres throughout Russia.

A new development since 1995 is the creation of innovation centres which has gained momentum since the approval in 1997 of the state programme "Promotion of Innovation". The programme foresees the creation of a network of innovation centres in regions with high scientific, technological and innovative potential and the formation of a network of regional training centres for innovation firms' staff. This programme is funded by two Ministries of the Russian Federation (the Ministry of Science and the Ministry of Education), by two government foundations (The Russian Fund for Technological Development and the State Fund) and by the regions willing to take part, on condition that they provide half of the necessary funds. The main difference between technoparks and innovation centres, apart from the different programmes which finance these establishments are that in technoparks innovation projects pass all the necessary stages of development until they result in a finished product, while innovation centres concentrate mainly on the later stages of product development. These centres should provide suitable and inexpensive premises for industrial and office use. The rents charged will be in the region of \$100-\$150 per square metre per year in order to cover the expenses of the centres, which are expected to become self-supporting. They are linked to a computer network with common access to professional databases, including a newly created database on research activity, know-how, product ideas and new technologies, which have been developed in the innovation centres and other R&D institutions. In order to fulfil this task an information-technological centre has been set up in Moscow. In 1997 total financing for this programme amounted to eighty-five million roubles (\$14.7 million)

which led to the creation of seven new centres (Innovatsii, 1998: 94), four of which are linked with existing technoparks. Two of these centres were opened in Moscow and St. Petersburg, and the others in Novosibirsk, Kazan and Ekaterinburg. They are located in vacated buildings with between 5,000 to 15,000 square metres of space. By the end of 1997 the total space of these centres already being utilised was 14,482 square metres in which 104 firms were accommodated employing a total number of 1,557 workers (Spiridonov, 1998a: 2). Total turnover of these firms was 120 million roubles (\$20.7 million) in 1997, an average of \$200,000 per firm (see table on page 286). This is almost four times as much as the average turnover of the firms located in the main technopark in St. Petersburg, due to the fact that this programme is aimed at firms which are already quite developed rather than at start-ups. An achievement of these centres is considered to be the fact that the amount of taxes paid in that year turned out to be almost a third of the state financing that they received (Spiridonov, 1998b: 2). The oldest innovation centres have returned the funds invested by the state in about two years in the form of tax payments (Burman, 1997: 26). They have proved to be a popular option for small technology-based firms. The problem of having empty spaces is rare; on the contrary there is usually a waiting list (Rychev, 1998: 73). At the beginning of 1998, twenty-six regional administrations and more than ten federal departments had shown interest in taking part in this programme. In the period 1998-2000 another 20-25 centres are planned which should accommodate a total of 500-600 small technology-based firms. In the plans of the government this should result in 10,000 new jobs in the sphere of innovative entrepreneurship and 25,000 additional jobs in industry, but it is not clear if these figures have any basis in reality (Spiridonov, 1998a: 2).

We have, therefore, two phases in the development of science parks. In the first phase science parks originated from universities in order to realise the commercial potential of research carried out by academics at a time when severe cutbacks in state funding obliged universities to find alternative means of support. The tenants, therefore, mostly consist of academics who

continue to work in their university, and often make use of university equipment for their new activity. Links with local industries are tenuous. From an economic point of view science parks have not proved to be a great success due to the severe demand constraints in Russia and to the fact that in many cases firms were created to receive financial support from the state and not from market considerations, as for firms belonging to technoparks it is easier to receive financial support. This point has already been emphasised by Batstone and Westhead (1996: 86) in a earlier analysis of Russian science parks. Nevertheless, the number of jobs created by firms located in the technoparks has been significant: 6,400 by the beginning of 1996 (Lur'e, 1996: 57). The second phase of their development has the state as a promoter. The role assigned to the innovation centres is to make technology-based products which can be used by the local factories. These innovation centres are not necessarily linked with a university, but may or may not be linked to research institutes. Innovation centres are still in the initial stages of development and it is too early to judge whether they have been more successful than technoparks. The advantage of innovation centres is that they can rely on the better founded programme "Promotion of Innovation", while technoparks have not been included in this programme.

Despite the great expectations, scientific entrepreneurship has had a limited impact on the economy. Science and technology was thought to be one of the main assets of the Russian Federation, the basis for an economic recovery once it was no more being planned centrally. It was expected that the wealth of knowledge bequeathed from the Soviet Union would give rise to a boom in the creation of technology-based companies, and that foreign investment would flow in large amounts in this sector, but neither of these expectations did materialise. There was a steep rise in the creation of small scientific firms<sup>6</sup> in the early nineties, but the majority do not seem to have survived long. The number of small scientific firms increased more than sixfold between 1991 and 1993 (from 10,000 to 65,000), compared with a threefold increase in the number of small businesses. It then decreased in

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<sup>6</sup> According to Russian statistical bodies a scientific firm is a firm involved in R&D and

the following years, while the total number of small businesses remained stable. There are no statistics on creation and closures rates, but according to two science parks managers, Melnikov and Ermilov (interviews), the decrease after 1993 is the result of the mass closure of scientific firms set up in the early nineties; new ones have been established, but in smaller numbers. The low scientific activity is emphasised by the fact that in Russia the registration of patents has decreased by 4-6 times<sup>7</sup> (Alekseeva, 1997: 17).

Judging from direct observation in St. Petersburg, many technology-based firms are struggling to break-even and only a small minority have prospered. Many of the technological innovations produced have limited commercial application. Even if the high academic and technological standards should provide favourable conditions for the development of innovation, business thinking is alien to many Russian researchers. According to the general director of the Regional Fund for the Scientific and Technological Development of St. Petersburg (henceforth Regional Fund), Fursenko, the main problem is not the lack of money, but the scarcity of viable projects. In his opinion the prevalent attitude is to realise scientific ideas within the framework of the state budget with little focus on commercialisation (Pashnov, 1996: 15). For this reason few technologies are commercially viable (Fursenko, 1998: 82). Scientists, instead, tend to have the opposite view. Melnikov believes that there are many people with good ideas, who cannot put them into practice due to a lack of finance.

Contrary to expectations enterprises did not take over the role of the government in financing industrial R&D. At present the amount of research financed by enterprises is very limited. The share of industrial firms introducing new innovations has fallen from 60-70%<sup>8</sup> in the late

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production which has not yet advanced to the stage of serial production.

<sup>7</sup> The author does not indicate which years she is comparing. She is probably making a comparison between 1996 or 1997 with the years immediately following the switch to the market economy.

<sup>8</sup> This share seems to be very high considering the very limited technological advancement of Soviet industry in the 1970s and in the 1980s. It is not clear what is meant by "introduction of innovation" by statistical bodies.

eighties to 6% in 1995 and keeps decreasing (Gokhberg and Kuznetsova, 1997: 19). Because of this industrial enterprises finance a decreasing share of total R&D expenditures, despite the collapse of overall R&D spending. Their share has fallen by four percentage points between 1994 and 1997, from 19.9% of the total to 15.3% (Kozhevnikov and Dedova, 1998: 88). The only positive sign is the increasingly important role being played by small enterprises, which in mid-1994, were found to be more active as buyers of new technologies than large enterprises. Over 20% of the purchase of new technologies in Russia came, in that year, from small enterprises, which is almost twice as much as their share of GDP (Avilova, Pripisnov and Chepurenko, 1996a: 143).

#### **7.4. PROMOTION OF INNOVATION IN ST. PETERSBURG**

St. Petersburg is the most important industrial, scientific and educational centre in North-Western Russia, and the second scientific centre in the whole of Russia. It boasts more than 390 research institutes and design bureaux, many of which are well-known abroad and the highest educational level in Russia (Lesage and Bayou, 1993: 30). About 20% of the Soviet R&D budget was allocated to St. Petersburg.

Due to the industrial crisis and to the severe cutbacks in federal financing, the scientific institutions, more than 70% of which in 1990 were still connected with the military industrial complex, are experiencing a serious crisis. The number of scientific workers decreased more than twofold between 1989 and 1994 (City of St. Petersburg 1994-1995: 22) and a further 25% left between 1994 and 1997 (Goskomstat, 1998a: 9). Wages of scientific personnel are among the lowest of all branches of the local economy. The average wage was 77% of the city's overall average in 1997 (Goskomstat, 1998a: 12).

Nevertheless, in 1996 the city still boasted 10% of all small scientific firms and employed 14% of scientific workers in Russia, despite having 3.3% of

the population (Rybakov, 1998: 6). St. Petersburg and Moscow both have 10% of workers engaged in science and education, the highest proportion in Russia. For this reason St. Petersburg represents a fertile ground for the development of technology-based firms. Unlike Russia as a whole where the number of scientific firms has fallen since 1993, their number trebled between 1992 and 1996 in St. Petersburg. The number of scientific firms in St. Petersburg subsequently stalled in 1997 and 1998. A widespread closure and opening of new firms seems to characterise this sector (interviews with Melnikov and Ermilov). This, rather than a sign of vitality, is a consequence of the low level of development achieved by most scientific firms. The average turnover in St. Petersburg was just \$15,000 per firm in 1997 (Goskomstat, 1998a: 15).

The local administration accorded the promotion of scientific firms low priority in the early years of the transition to a market economy. The only source of financing for these firms came from the regional branches of the national funds and from a number of venture funds financed by the EBRD and other corporate and private investors operative in St. Petersburg.

The State Fund has been represented in St. Petersburg since 1994 by the company, ILIP, which managed the most important science park in the city up to 1998 and then an innovation centre. In St. Petersburg, the State Fund financed innovation projects with 1.232 million roubles (\$270,000) in 1995 and more than six million (\$1.2 million) in 1996 (Kiselev, 1997a: 20).

The Regional Fund, which is a representative of the Russian Fund for Technological Development, but also collaborates with the State Fund, is a non-profit making organisation founded in 1992 to foster innovation-led activities in St. Petersburg and the surrounding region. The Ministry of Science has also assigned it the role of information-consulting centre for the North-West of Russia for the purpose of promoting collaboration in the scientific sphere between the Russian Federation and the European Community. In addition to providing finance the Regional Fund organises

training courses for managers of small and medium-sized technology-based firms, and provides consulting to technology-based businesses on subjects such as marketing, insurance, search for investors, business planning, patents and other legal matters. Since 1998 the Regional Fund has also provided guarantees to banks which are prepared to lend to technology-based firms. Up to May 1998 seventy projects submitted by the Regional Fund had received financing for a total amount of \$9.5 million (Fursenko and Nikkonen, 1998: 4). Fifty-five of these were financed by the Russian Fund for Technological Development, eight by the State Fund and seven from other sources. The number of jobs created from these ventures had amounted to approximately 1,200 by September 1997 (Nepomiashchaia, 1997b: 2). Decisions on the projects to be financed are taken in Moscow on the basis of the recommendations of its regional representatives who assess business plans of applicants from a scientific and economic point of view. Even once credit has been granted the activity of the firm is regularly monitored. As declared by the director of the Svetlana Innovation Centre, Spivak, a project has a better chance of being approved if it is proposed by the Regional Fund (as well as by ILIP) because of the authority this enjoys. Eighty per cent of the projects proposed by the Regional Fund received financing.

In order to promote innovation, the Committee for Economy and Industrial Policy of the St. Petersburg Administration created the Innovation Council inside the city administration in October 1996. This council is responsible for drafting proposals on this subject and implementing the city innovation policy. The Council is comprised of the representatives of the technoparks and innovation centres based in St. Petersburg, the Union of Industrialists and Businessmen of St. Petersburg and the local administration. The development of a system of integrated innovation centres, technoparks, financial institutions and investment agencies geared to financing innovation is listed as one of the main objectives of the Strategic Plan of St. Petersburg adopted in 1997. Another measure indicated in the Strategic Plan to stimulate innovation is the creation of a favourable legal

environment for science, innovation and education. A law ("On Science and Scientific-Technological Policy of St. Petersburg") establishing that every year no less than 1% of the expenditures of the St. Petersburg's budget will be assigned to finance a package of scientific programmes and projects has been drafted, but has been stalled by the assembly. This law will also introduce a number of tax breaks for scientific organisations and scientific enterprises.

In order to give a new impulse to this sector the strategy chosen by the city is to encourage stricter collaboration between industry and scientific centres. The city has organised a competition for the creation of ten innovation centres over the next few years in which it has received more than thirty applications. Requests to set up new innovation centres must be jointly proposed by industrial enterprises and institutes of higher education or institutes belonging to the Academy of Sciences. For the creation of the innovation centres the enterprise supplies the premises and also its equipment if it is appropriate and the scientific organisation contributes the researchers and the scientific know-how. The industrial enterprises chosen to house these centres will be given tax concessions (Eskin, 1998b: 6). The objective is to exploit unused buildings and equipment which lies idle in local factories, and to provide additional employment for the researchers who are often in desperate need of it. The Innovation Council, with the assistance of two independent expert organisations, will select the successful centres. The city planned to allocate financing for this programme in 1998-1999 on an equal basis with the participants of each project, but the lack of approval for the programme of small business support by the city assembly has delayed this. By law federal authorities should allocate to these projects the same amount of money as that provided by regional authorities. These centres, which will have an independent legal identity, will receive financing for repairs to the buildings on a grant basis, and to buy equipment on a loan basis (Viktorov, 1998: 7). Priority will be given to the projects which need less expenditures to be viable. Some of the buildings proposed for use are empty buildings which need to be

completely restructured, while others require only minor adaptations. These centres will provide consulting services and training for technology-based firms and will be equipped with, among other things, an information network with access to the Internet and other international databases and autonomous energy supply.

In the plans of the local administration these new innovation centres will have strong links with the host enterprises in order to orientate their research towards the needs of the latter. Twenty-five per cent of the space should be reserved for start-ups. The objective is to produce scientific innovations<sup>9</sup> which can be utilised by the host factories or by other large enterprises in the city. Eskin (1998b: 6), the deputy director of the Committee of Economy and Industrial Policy, says that the problem of the current science parks is that they often produce products which are not required by the market, even if he considers the science parks in St. Petersburg to be quite successful in this respect.

As of the beginning of 1998 there were two technoparks and three innovation centres operative in the city; the newest was set up in 1997 under the programme Promotion of Innovation. In addition, a technopark is at the stage of being set up in the Institute of Mechanics and Optics and a business incubator is to be opened following an agreement between the local administration and a French firm which specialises in the creation of this kind of centre. This incubator will be managed, at least initially, by French specialists, while the city will provide the building and equipment. There are also a number of organisations calling themselves technoparks, but which cannot really be defined as such: these cater for consulting firms or other non-technology-based firms. The biggest technopark in St. Petersburg, the Baltic International Scientific-Technological Park, was closed in mid-1997. This technopark was created in 1993 to promote co-operation

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<sup>9</sup> The distinction between inventions and innovations is that inventions are "an idea, a sketch or model for a new or improved devise, product, process or system.... An innovation is accomplished only with the first commercial transaction involving the new product or process, although the word is used to describe the whole process" (Freeman, 1982: 7).

between European companies and research institutes, universities and defence industries of St. Petersburg and had among its founders the city of St. Petersburg, the Baltic State Technical University and two large Italian companies. However, it was mainly utilised as a commercial structure: in its 13,000 square metres of space throughout the city just twenty-five of the eighty enterprises accommodated were technology-based firms (Voloshin, 1997c: 2). Owing to bad management it was on the brink of bankruptcy at the beginning of 1996. A change in its management staff did lead to an improvement, but the city administration and the university decided in any case to close it one year later. This decision may have been taken in order to utilise the premises in a more profitable way.

## **7.5. SCIENCE PARKS IN ST. PETERSBURG**

### **7.5.1. FEATURES**

Among technoparks and innovation centres the oldest dates back to 1991 while the others were set up in 1994 and 1995. One of the innovation centres (henceforth ICS) is located in a major factory of St. Petersburg named Svetlana, another (henceforth ICTU) is located in the Technical University and the third is based in the Electrical Engineering University. The two technoparks are also located in these universities. Extensive interviews were carried out with the managing staff of two technoparks and two innovation centres in St. Petersburg. The innovation centre of the Electrical Engineering University was not analysed as in 1998 it was in the process of being set up. Only one of these, the ICS, has a distinct juridical entity, while the two technoparks are subdivisions of two different universities, and the ICTU is managed by a non-profit making organisation, the TBH Fund, set up for this purpose in 1995, when the innovation centre was established. The TBH Fund, which was set up by the State Fund, the Technical University, a branch of the Academy of Sciences and a few private firms, is one of the three organisations collaborating with the city administration to carry out the federal programme Promotion of Innovation

and is also involved in the evaluation and selection of the scientific projects to be financed by the above-mentioned State Fund. The ICS is a non-profit making organisation, which has been set up by the Regional Fund at the end of 1995 together with the government of St. Petersburg and the Russian Ministry of Science. It is the only one of these structures not linked with any university, but collaborates with industries and scientific organisations of the North-Western part of Russia.

The technopark of the Electrical Engineering University (this technopark will be subsequently called TEEU) set up in 1991 was one of the first technoparks in Russia and the very first in St. Petersburg. The Electrical Engineering University where it is located is one of the oldest in Russia and a renowned centre of domestic science. This park is considered nowadays to be the fourth most important in Russia. Two of the first three are located in Moscow and the other in Tomsk. The TEEU was initially named Ekopark because the aim was to develop technological projects in the ecological field, but the scarcity of projects with commercial potential led to a switch to the more general objective of exploiting the intellectual potential of the university and providing employment for graduates. A formal procedure of admission to the university parks does not exist as any technology-based firm created by academics of this university is automatically a member of the technopark, while outside firms are not accepted. Firms generally continue to be members of the technopark even if they choose to leave the university and find premises in the city because it is advantageous for them to have their name associated with the university. It inspires more trust among clients. The technopark of the Technical University (henceforth TTU) set up in 1994 is also aimed at favouring start-ups from university staff. Nevertheless, not all the technology-based firms created by university staff are members, though they would be charged less rent. In the Technical University there are about twenty more technology-based firms created by its staff which have never requested to enter the technopark, because in the opinion of the vice-director of the technopark, they fear that the university might interfere in their activity. In reality, the interference in the activity of

the tenant firms is minimal and no information on the firm's activities is required by the university. The universities are very accommodating towards tenant firms. Sometimes, upon request from the firms, reductions in the rent can be conceded. This is usually done for firms which have just been set up or in cases where firms have financial difficulties which the technopark management believes can be rectified in the future. In the TTU tenants will not be evicted from their premises, even if they fail to pay the rent. In this case the university may look to alternative solutions, e.g., they may do some work on behalf of the university.

The innovation centres have a more commercial profile and, therefore, are more selective in the choice of tenants as they have to become self-sufficient and repay the debts arising from reconstruction of their premises. The target of becoming financially independent is, however, still elusive in the opinion of the director of the TBH Fund, while the ICS having reached the target of accommodating twenty firms by July 1998, six months early, should have become financially autonomous. The ICTU requires firms to be science-based and financially secure. The director says that at present the centre cannot afford to accommodate new firms. Due to financial constraints it is necessary to ensure that these firms can pay the rent which is well below market value. The ICS has, instead, accepted both existing and new firms which have spun-off from the Svetlana factory because one of the aims of the centre is to create a mutually advantageous relationship between the factory and the small technology-based firms. In the ICS tenant companies are chosen via open contests by the board of the innovation centre after an evaluation of the feasibility of the project. Firms must provide their last balance-sheet, a copy of the company's registration and their business plan. The agreement between the firms and the centre dictates that 60-70% of the turnover must come from high technology. Both innovation centres offer long-term rents (up to three years) which in the ICS is subsidised for start-ups and increases in proportion to the firm's turnover. If a firm wants to leave the ICS and buy

its own production premises the Regional Fund can act as financial guarantor.

### 7.5.2. PREMISES

Specifically built premises are provided by three of the four establishments herein considered. The TEEU has a main building of 1,000 square metres, built in 1994 with state financing, where research and small-scale production can be carried out for a limited number of firms (in 1998 there were twelve firms, eight of which involved in industrial production), with up to twenty employees. Rent is set at approximately half the market price. The remaining firms are located in the departments of the University. The total space occupied by technoparks' firms is 4,527 square metres. In 1997 the local administration gave the technopark another building of 1,377 square metres, which belonged to a bankrupt state firm, to house the innovation centre. This building, equipped for small-scale production, has space for eleven small firms with up to 150 workers, which will be selected through open competition. The innovation centre has the status of an independent company, but is managed by the same firm ILIP<sup>10</sup> which managed the TEEU up to 1998 and is provided with the same support services. It will have a more commercial profile compared with the TEEU because of the necessity to repay the debts arising from its construction. For this reason it will house only financially healthy firms which can guarantee the payment of the rent. The TTU has never benefited from any state financing and for this reason it is rather underdeveloped. It does not have its own building for the tenant firms, which are scattered around the university. The innovation centres have, by contrast, much larger tailor-made premises.

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<sup>10</sup> The joint-stock company "Innovation of Leningrad Institutes and Enterprises" (ILIP) is one of the seven firms which make up the infrastructure of support for firms belonging to the technopark. It offers consultation on specific business matters. It is the representative of the programme "Support for Small Entrepreneurship and New Economic Structures in the Scientific Field Operating in Higher Institutes of Education" and of the "State Fund for the Support and Development of Small Business in the Scientific and Technological Sphere". ILIP was set up by the university to commercialise university research in 1989. It was one of the first firms of its kind in Russia, at a time when a system for funding the commercialisation of university research did not exist.

The ICS occupies a space of 4,500 square metres in an up-to-date production building inside the Svetlana factory, one of the city's largest instrument-making manufacturers in St. Petersburg which was in 1998 working at 20% of its production potential. The factory itself has a very run-down appearance. The ICTU was set up in 1995 in a building belonging to the Technical University which was heavily damaged by fire a few years before. Up to mid-1998 3,500 square metres had been reconstructed and a further 2,500 are expected to be ready for 1999. These were previously vacant buildings, provided by the host institutions as a contribution to these centres' capital. They were then adapted in order to meet the engineering and technological requirements of the firms. For this purpose the TBH Fund received financing from the State Fund, mainly in the form of a ten-year loan, although a small part was on a grant basis, while in the ICS the capital expenditure, which on the first of January 1998 amounted to about \$1 million, was financed from a variety of sources: the Ministry of Science - 19% of the total - the city budget - 23% - and the above-mentioned Regional Fund - 58% - (data provided by the V. Spivak, director of the ICS).

### **7.5.3. CONSULTING AND SERVICES PROVIDED**

Science park staff are mainly involved in managing the park and assisting in business planning, in the search for financing and partners for the tenants and in organising participation at various trade fairs, but participation in the management of the tenant firms themselves is very limited, unless specific assistance is required, usually when a firm is experiencing serious difficulties. An economic and technical evaluation of the business plan is carried out with the assistance of outside experts when a loan is requested. Consulting is provided by the staff of technoparks and innovation centres usually free of charge, while in innovation centres these services are provided at a price as the centres must be financially autonomous, although lower rates are set for firms at the early stages which are not yet self-sufficient.

Innovation centres have a larger staff because they also have to supervise the reconstruction of the building and prepare the premises according to the requirements of the tenant firms. The ICS is managed by the Regional Fund which has about thirteen members of staff, although they are not only involved in the management of the centre, but also in the running of the Regional Fund, while the TBH Fund, which manages the other innovation centre, has about ten people, and the TEEU has two full-time and eight part-time employees. In the Technical University there are three staff members whose duties relate to the technopark (the director who reports directly to the university administration; the deputy director who provides free consulting for the tenant firms and the director's secretary). In reality only the deputy director is actively involved in the management of the technopark. The director has occasionally consulted one of the tenant firms on technical matters, as he is a specialist in its field, but his involvement in the management of the technopark is very limited. This technopark is highly dependent on the deputy director who despite his age - he is more than seventy years old - is still very active and has a wide network of contacts in Russia and abroad. Despite the limited amount of financing provided by the specialised funds financing small scientific firms, these technoparks have been remarkably successful in providing finance for tenant companies. Four of the five firms which applied had received financing in the TTU, while in the TEEU twenty-two projects were financed by the three main Russian Funds in 1995 (Innovatsii, 1996: 24).

In addition to its own staff the TEEU also has an infrastructure of support for small businesses made up of seven firms which provide a variety of services at a price set below market value for tenant firms. They offer consulting in business planning, accounting, marketing and transfer of technology in both the domestic and foreign markets, publish educational and scientific literature for tenant firms, certify and test scientific products in conformity with domestic and international standards, organise training for quality control managers in accordance with the ISO-9000 standard and

management training in collaboration with the Catholic University of Louvain (Belgium). The technopark also offers the possibility to the tenant firms to participate in several national and international trade fairs at the expense of the State Fund.

The ICS and the ICTU also offer to their tenants a wide range of information and consulting services comparable to those provided in the West, but have to rely on the Regional Fund and the State Fund for the provision of most of the services to the tenants. A training centre is also operative in the ICS in which more than 200 people have been trained. Until now, however, in the ICTU the level of requests for consultations has been rather modest, as tenant firms are already quite developed. Sometimes firms themselves have provided consultations to the TBH Fund regarding technical problems in the reconstruction of the building.

All four offer shared rooms with office equipment (photocopiers, fax machines and computers) which are freely available for tenant firms, but in the TTU these services are utilised only by the firms located nearby as tenants are scattered around the university. Technoparks also offer the possibility of renting university equipment on an hourly basis, while the ICS offers the opportunity to make joint use of the testing and other technological equipment available in the centre, and even to buy this equipment. The ICTU, by comparison, offers few facilities, just a common room with some office equipment and a conference room, as almost all tenants are in a financial position to be able to afford to buy the necessary equipment themselves. For the same reason they do not rent equipment per hour like the firms of the technopark based in the same university. The equipment of the university is in any case considered to be too old to be of any use to these companies.

#### 7.5.4. TENANT FIRMS

The number of firms accommodated in these structures ranges from ten to forty-five. The main requirement to be accommodated in these places is that firms are of a scientific nature. This means they must have a patent or a licence to exploit a patent. There is no time limit on how long firms may remain in the technopark, and this seems also the case for most of these structures in Russia.

No real interaction exists among firms of the TTU as these are scattered around the university, often far from each other. This is true also for the firms located in the ICTU given the fact that they work in different sectors. This is not unusual as research has shown that science parks provide little if any benefit in terms of increased networking (Deakins, 1996: 166). Networking among firms is instead, according to the director of the TEEU, more developed there as there are more firms working in the same field, but more detailed research would be necessary to assess the benefits of this activity.

In the TTU the number of firms has grown from three to eleven between 1994 and 1998, seven of which are technology-based firms, while the remaining four belong to other sectors and have been accommodated in order to cover the expenses of running the technopark. The non-scientific companies chose to belong to the technopark because it is advantageous for them to have their name associated with the university. All, but one of the technology-based firms of the TTU, have been set up by university staff, who have continued to work for the university. Eight patents, three of which belonged to enterprises which have closed were registered until October 1998. In the development of innovative projects the firms usually utilise the industrial equipment in the faculties of the academics turned entrepreneurs. The equipment is rather old - the average age being ten years - but neither the firms nor the university can afford to replace it. Budget allocations for the university are just enough to cover personnel expenses in

spite of the fact that academic salaries are very low - below the Russian average. The turnover of these firms ranges from \$10,000 to \$200,000 per annum and the number of employees from four to thirty. In total about 150 people are employed in the firms belonging to this technopark. The low turnover per capita testifies to the scarce development of these firms until now. Now only a couple of firms are prospering, while the turnover of the other firms is at best stationary and at worst in decline especially for the producers of medical equipment, as allocations for health in the city budget reached a record low in 1997. Three out of the five firms which closed in 1996 and 1997 after about three years of existence also produced medical equipment. In view of the limited possibilities to sell high-technology products domestically, the deputy director is nowadays striving to find clients abroad. Several contacts have been established with foreign companies, but only one firm actually found customers abroad (in Eastern Europe and China). This firm builds, reconstructs and improves the efficiency and environment-friendliness of boilers in thermo-electric stations.

The financial situation of most of the forty-five TEEU tenants is not much different. According to the director fifteen firms are doing reasonably well, while seven have almost ceased to function and the others are keeping afloat. The two most successful firms had a yearly turnover of \$1 million and \$300,000 respectively in 1997, while the average turnover per firm was close to \$50,000 in that year (Kiselev, 1998: 4). Despite the difficult economic environment a significant number of jobs has been created. These firms have provided 200 full-time positions (an average of four per firm) and 1,400 part-time jobs (an average of twenty-eight per firm) (Innovations, 1998: 27). Most of the part-time workers also work in the university. All but a few firms have the Russian Federation as their main market. Only 5-6 firms have been able to find a market abroad.

The average turnover of firms in the innovation centres is much larger than that in technoparks. In the ICS the average turnover is \$140,000 (Fursenko

and Nikkonen, 1998: 4), while in the ICTU is \$250,000. The higher turnover compared with technoparks is due to the fact that the innovation centres focus on firms which are already quite developed rather than start-ups. The average number of people employed is also much larger. In 1997 it was twenty-one per firm in the ICTU and twenty in the ICS, so that total employment in tenant firms of the ICS amounted to over 300 jobs by the end of 1997, plus 200 in sub-contractors. All of the twenty small enterprises accommodated in the ICS by July 1998 have become financially self-sufficient. The ICS centre was declared by the Ministry of Science to be the best innovation centre in Russia giving it the right to receive loans at favourable terms in order to realise new innovation projects. The success of the centre is demonstrated by the fact that according to an estimation of the number of small firms interested in becoming tenants the centre will have to more than double the available premises to 10,000 square metres. The creation of a technopark is also forecast by the year 2002, in which five-ten firms will have production premises of up to 1,000 square metres with the right to utilise all the services provided by the Regional Fund. The only source of disappointment has been the weak relationship between the innovation centre and the factory where it is located (Eskin, 1998b: 6). This is despite the fact that some tenant firms were spin-offs from this factory. The management of the factory hoped that the companies belonging to the innovation centre would provide additional work for the factory and that it would be possible to create joint-ventures between the factory and the small technology-based firms with the objective of utilising their R&D in production, but this has not yet taken place.

TABLE 7.1  
Main indicators regarding technoparks and innovation centres

YEAR 1997	TEEU	ICS	ICTU	7 Inn.Cen.*	All University Techno.
Number of tenant firms	45	15	7	104	1,000
No. of employees of tenant firms**	1,600	300	150	1,557	
Total turnover of tenant firms***	15,000	12,000	10,000	120,000	200,000
Turnover per firm in dollars	57,620	138,289	246,944	199,455	34,572
Turnover per employee in dollars	1,621	6,914	11,524	13,323	

Techno.=Technopark s Inn.Cen.=Innovation Centres

\* seven innovations centres participating in the state programme "Activation of Innovation"

\*\* including part-time employment

\*\*\* in thousands roubles

The ICTU hosted, in October 1998, ten technology-based firms with a total number of 250 workers, but the objective is to accommodate twenty-three firms, once the building has been completely renovated. About half of the firms were created by staff of the Technical University. Two firms have left the centre in recent years, but this was due to financial difficulties. The ICTU does not have a stated profile of activity; tenant firms are all mature firms set up five-seven years ago which work in different sectors: software programming, renovation of small hydro-power stations and historic monuments, production of welding equipment, acoustic amplifiers, medical devices, etc.. Two firms are very small, one having only one employee and the other four employees, but the four biggest are relatively large compared to the usual standards of innovation centres; they have thirty-one, thirty-six, fifty and sixty-one employees respectively. Almost all of them have two different activities. These firms are characterised by their high propensity to export. In total six of the ten firms have some kind of collaboration with Western partners. Two work only for foreign clients, while the markets of the others include the Baltic States, the Ukraine and Belarus. The most successful is a firm of software production which employs sixty-one programmers and occupies an entire floor. It was financed by a group of American business angels and it works exclusively for a software house in the United States. Software production is one of the fastest growing sectors in Russia. Some of the biggest software houses in the West outsource to Russian companies the development of software and Internet tools taking advantage of the abundance of well-trained engineers.

#### **7.5.5. AN ASSESSMENT OF SCIENCE PARKS IN ST. PETERSBURG**

As a rule, the objectives of science parks can be divided into four categories (Broadhurst, 1993: 35):

- the creation of new enterprises in order to generate new jobs and wealth.
- the transfer of technology from academic institutions to industry.

- the commercial exploitation of existing or newly developed technologies.
- the realisation of income for the founders and the increase in the value of the premises.

The fourth point in Russia applies only to the most advanced science parks which offer high-quality accommodation where rent is close to market levels. Regarding the second point, the transfer of technology to industries has been weak until now. In St. Petersburg some success has been achieved only by the ICS whose technologies have allowed the creation of 200 jobs in local industries (Fursenko and Nikkonen, 1998: 4). Subcontracting of research to tenant firms on the part of industry is also very rare. According to Salov, editor of the magazine "Innovation" based at the TEEU, the major industrial firms might be interested in subcontracting research, but cannot afford to do so. Even in the few cases where research has been subcontracted, payment difficulties have arisen. It is very difficult to assess the net contribution of science parks regarding the other points as there are no comparative statistics on technology-based firms in and outside parks. We cannot judge the effectiveness of these science parks from the rate of surviving firms as some of them are almost inactive. In Russia, the mechanism for bankrupting firms is hardly ever applied. The number of jobs created by the technoparks' companies has, however, been significant considering they are all new firms. The cost per employee has not been very high given the limited amount of financing provided. In general, we can say that these science parks have demonstrated that through their influence on public and private resources they have been successful in providing financing for tenant firms, but have not yet demonstrated an ability in promoting self-sustaining growth. This task is almost impossible to achieve considering the current economic conditions. The realities of the declining Russian economy mean that there is very little demand for high-technology products. While as underlined in a empirical study on Finland the main clients of new technology based firms are larger firms in different industry clusters of the Finnish economy (Autio and Yli-Renko, 1998: 88)

this market outlet is very limited in Russia. The number of firms which have reached the stage of serial production is very limited. Almost all the firms in technoparks would be classified as rather “soft” according to the Bullock model<sup>11</sup>, while in innovation centres they tend to be “harder” because they mainly accept firms which are already developed. Yet, even in innovation centres the average turnover per head is just \$10,000.

Contacts with foreign partners have become more and more frequent in the last few years, since science parks have participated in several international trade fairs and conferences. A network abroad is already quite developed in the TEEU. Collaborations have been realised by the park in the fields of environmental monitoring with firms and science parks in Germany, Finland and China and in the promotion of innovative products in international markets with several foreign firms specialising in these fields. However, up to now technoparks have not been very successful in attracting foreign capital nor in finding markets abroad. In the TEEU there are three joint-ventures, while in the TTE none. This applies less to innovation centres because of the policy of accepting more developed firms. At present the sale of high-technology products in foreign markets is hindered by the fact that the costs of acquiring the necessary certificate and patent is very high for the average high-technology firm. For this reason only 1% of Russian patents are registered abroad (Alekseeva, 1997: 17). Another obstacle seems to be the lack of marketing skills which is one of the major weaknesses of these technology-based firms. Usually they cannot afford to have a marketing department and even if they can they earmark few resources for this purpose. It is still not in the Russian mentality to spend

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<sup>11</sup> A model explaining the birth and development of technology-based firms, the “soft-hard model”, has been developed by Bullock (1983: 11). According to this model many technology-based firms are set up by academics as “soft” companies. These are companies created with low capital outlay where the academic is engaged on a part-time basis while continuing to exercise his previous occupation. At a later stage when the market opportunities have been better evaluated the academic might decide to work full-time in the new company in order to render a more customised service. The third and fourth stages concern the manufacturing of a new product on a limited scale - even merely a prototype - and full-scale production. At each stage the business becomes harder. However, the evidence on the validity of this model is rather inconclusive. Indeed, evidence regarding Great Britain has pointed out that the passage from soft to hard takes place only in a few cases (Monck and others, 1988: 139).

money on marketing. For this reason they seem to give little consideration to the need for consulting in areas such as marketing.

In St. Petersburg science parks do not have an official advisory board as usual in the United States. The director reports directly to university administrators or to their other founders in the case of innovation centres. The role of the science park staff is primarily to market and manage the park, while business assistance to the tenant companies has been limited to consultations on the drawing up of business plans and on the search for financing, partners and markets abroad. They are usually content with maintaining a general interest in the activity of the tenant firms, but participate very little in their management. The information that they generally receive from tenants is confined to data on turnover, personnel and payment of taxes. No formal review of the firms' performances is carried out at the end of the year. On the other hand tenants seem to be reluctant to provide anything more than the basic information required to external people. In general, tenant firms seem to be very reluctant to open their accounts even to the management staff of science parks; none of the science park managers mentioned bookkeeping when listing the services requested by tenants.

The limited degree of consulting provided is at odds with the concept of science parks, which is to assist new entrepreneurs, since a good proportion of these have a technical background and little or no management experience. In science parks around the world this is precisely one of the main reasons why companies locate in these places. However, as is the case in the United Kingdom the utilisation of management advice was found to be very limited in some science parks, even if tenant firms were experiencing difficulties, and in a few, it was almost non-existent (Monck and others, 1988: 190).

What distinguishes Russian science parks from their Western counterparts is the very unattractive surroundings. While Western science parks tend to

be spacious, attractive and well-landscaped, Russian science parks do not look very attractive from the outside, as they are located in run-down areas (ICS, ICTU) or in basic-looking buildings in the university (TEEU), but currently this is not seen as a handicap. The entrepreneurs are more concerned with the infrastructure of the park. Innovation centres and the TEEU, for a limited number of firms, provide the possibility of renting for several years without the risk of being evicted at short notice, premises tailored to the requirements of the tenants at a price which, at least initially, is often below market rates. Other pluses include the guarantee of a reliable energy supply, a common security policy which protects tenants from undesirable visitors and also the supply of other facilities. Nowadays modern buildings and up-to-date infrastructures are a scarce commodity in Russia, and even if their supply is increasing most new firms find the prices unaffordable.

Indeed, it seems that in Russia firms might find science parks attractive not because the local scientific milieu is important for their operations, but because these places offer a range of services and good quality accommodation. Science parks should be seen more as service organisations providing a range of business support facilities to technology-based firms than scientific centres of excellence. Even if it was not necessarily the original aim of the founders of such structures it may nevertheless represent a significant contribution to the development of technology-based firms. It must be noted that world-wide many science parks can be covered by this definition having not met the most optimistic expectations of producing leading-edge technology (Autio and Klofsten, 1998: 33).

## **7.6. CONCLUSION**

With little finance from the state and a limited potential to market research because of the scarcity of demand, the importance of the science sector in the Russian economy is waning. St. Petersburg is no exception in this

matter. There is little the local administration could have done to avert this, given its financial straits. There is, however, scarce evidence to suggest that it has made any serious effort, until the late nineties following the appointment of Klebanov in the city administration. He brought some innovative ideas. For example, measures to direct research towards the needs of local industry have been envisaged. Russian universities have been actively involved in the creation of science parks. Despite the severe demand constraints the firms nurtured by technoparks have provided a distinct number of jobs for academics. It is probable that without the assistance of these structures many of these firms would not have been created and would not have been able to receive financing to continue their activity. The possibility of obtaining consulting does not seem, however, to be exploited in full. For example, marketing is seldom requested by tenants despite the fact that few employ specialists in this field. The weakness of the existing technoparks has been the scarcity of collaboration with local industry. The second phase has as a sponsor the state which through the special programme "Promotion of Innovation" has financed the construction of state-of-the-art innovation centres, whose aim is to make technology-based products which can be used by the local factories. These innovation centres are not necessarily linked with a university, but may or may not be linked to research institutes. Innovation centres are still in the initial stages of development and it is currently too early to judge whether they will be more successful than technoparks.

## 8. CONCLUSION

The thesis is divided into eight chapters. The first two chapters cover the main theories on entrepreneurship and its development in Eastern Europe and Russia in the nineties, the business environment in Russia and the specific state policy towards small business with a final section on the factors which have led to its slower development in Russia as compared with the other transition countries. A critical analysis of small business statistics is carried out in the next chapter. The remaining chapters are on St. Petersburg. A macroeconomic overview of St. Petersburg in the nineties is provided together with an assessment of the local political situation; local fiscal policy and local economic policies. Next, the measures undertaken by St. Petersburg to promote small business are compared with those of Moscow to detect the factors which, in these two cities, have led to the large expansion of this sector. Chapter six and seven focus on the information I gathered in St. Petersburg (qualitative interviews, responses to questionnaire and case studies of science parks), which forms the empirical basis and allowed me to examine how entrepreneurs are affected by the business environment in the city.

My conclusion consists of two parts. In the first part I examine the Russian context of transition including the factors which are believed to have affected small business climate. In the second part the focus is on the specific situation in regard to small business in St. Petersburg.

Small business in Russia has not fulfilled expectations, either in the late Soviet period or since the communist downfall. Legalised in the second half of the eighties to improve the availability of goods which were in short supply in the Soviet system, it was initially expected to function within a system which was to remain largely planned. Instead, it might have exacerbated the scarcity of these goods and, by making the internal contradictions more evident, accelerated the fall of socialism. Similarly, the economic transition in Russia has been characterised by the limited

development of small business which has been particularly disappointing when compared with the leading transition countries, especially Poland and the Czech Republic. The growth in this sector in Poland and the Czech Republic seems to have been an organic process once economic deregulation has been conceded as policy making has devoted little attention to the emergence of entrepreneurship despite the key role it was supposed to play in the economic transition. A natural question, therefore, is why Russia differs. Mainstream small business theory is of little help given the particular conditions of the transition from a planned to a market economy. Entrepreneurs' personalities in Russia have been found to be quite similar to those in advanced market economies and the system of cultural values, which came into being in the last decade, is very sympathetic to entrepreneurship. The main reasons for the poor development in Russia put forward in the thesis are the following:

- historical reasons which contributes to the lack of entrepreneurial culture
- Olson's theory about the existence of strong interest groups which shares common ground with Baumol's theory on relative rewards for different types of economic activity.

The first explanation suggests that Russian entrepreneurs have less experience than their Eastern counterparts and therefore less developed business skills, reflected in higher failure rates. This is because, unlike Russia, in the leading transition countries a strong entrepreneurial sector was present before the communist take-over, communism lasted slightly more than forty years instead of more than seventy and domestic firms had more interrelations with Western counterparts. In addition, in two of these countries some entrepreneurial activity was allowed. The result is that key business skills such as marketing, market research, financial planning and budgeting are alien to Russian entrepreneurs and it will take a while before they are able to acquire these. For this reason, even if the new favourable attitudes to entrepreneurship have encouraged the creation of new firms, failure rates have been extremely high.

Olson's contention that the existence of strong special interest groups in a country limits its ability to adopt new technologies and reallocate resources as a result of changing conditions is particularly relevant in Russia where the strong power of interest groups has led to the concession of extremely favourable conditions for well-connected individuals and has strongly influenced economic policy. On the contrary, in the leading transition countries, where the political leadership has been largely replaced, domestic policy has been less dominated by vested interests and "rules of the game" have been clearer and fairer. As a result of this and of the lack of clear rules, the relative rewards for different types of economic activity have favoured the allocation of entrepreneurship to largely unproductive activities, such as rent seeking and organised crime, rather than to productive activities.

The phenomena described above can, to a greater or less extent, be identified as having given rise to the following six conditions, which have had a much greater impact in Russia, than in the leading transition countries, and have acted as a constraint to small business development:

1. high levels of corruption
2. income inequality
3. a business-unfriendly legislative framework and the general situation of instability caused by the lack of clear rules
4. the scarcity of financing for small businesses
5. the precarious state of large industrial enterprises
6. a high level of crime

1. Corruption is one of the main factors indicated by the entrepreneurial class which adversely affects their activity. Russia has become one of the most corrupt countries in the world in the nineties, a phenomenon which was not so acute in the eighties, when its incidence was lower than in some East European countries. As the higher echelons of power have been guilty of one form of corruption or another in the eyes of the population and asset grabbing has been going on practically unchecked,

their behaviour has been replicated by lower strata of the bureaucratic structure. The poor salaries of state employees has also acted as a moral justification for their behaviour.

2. Income inequality has passed from being very moderate at the beginning of the decade to becoming one of the highest in the world, while the variation has not been substantial in Central Europe. The large increase in income inequality has been particularly damaging because the new rich have indulged in conspicuous consumption and saved their wealth abroad, without investing in the domestic economy. The existence of a middle class with the financial resources to engage in entrepreneurial activity is still marginal, except in Moscow, St. Petersburg and few other cities. At the same time the poorer classes hardest hit by the transition have been hardly able to afford education, resulting in decreased educational attainment.
3. A complex yet deficient legislative framework is one of the features which has characterised the poorly performing transition countries in relation to the leading transition countries. In Russia the legal framework is characterised by an obstructive regulatory regime, high taxation and conflicting and convoluted legislation. Since taxation takes away about 80% of a company's profits the entrepreneur is left with no other option than carrying out a significant proportion of a firm's activities in the non-regulated sector. Opening and managing a business is more complicated and subject to greater bureaucratic interference than in the leading transition countries. In Russia a clear delimitation of power among the bodies which can enact legislation is lacking. The result is an array of conflicting rules, so that for an entrepreneur it is impossible to follow the law. The entrepreneur is, therefore, subject to the whims of the supervising bodies. As emphasised by some leading authorities, favoured groups might have had an interest in avoiding the implementation of a clear legal and tax framework, as their business dealings have been conducted on the fringe of the law and in order to prevent the emergence

of new economic actors who could challenge their dominance, but no conclusive evidence can be provided on this point. It might also be argued that this is the result of the fact that historically there has been little respect for the rule of law in Russia. Whatever the reason for this (probably a combination of these two factors), after almost a decade, legislation seems to serve the purpose of discouraging business, rather than providing a framework in which it can prosper. The Russian tax system favours consumption over investment, being particularly punitive on manufacturing activities, and is therefore a serious impediment to growth. For years a simplification has been on the agenda with the enactment of a new tax code, but up to the early 2000 the enactment has still not been put in place.

4. Financing for small business has been extremely scarce. The banking sector is much smaller than in the leading transition countries and the quantity of loans conceded to small business is negligible. Banks have been very cautious in financing small businesses, especially new start-ups which are considered too risky, given their high failure rate. Part of the blame lies with the state policy which encouraged the banks to invest in state bonds, instead of in the real sector. Then, the state-induced collapse of the banking system led to a dramatic decrease in the amount of credit going to small businesses. Programmes intended to develop small business have also remained largely unfulfilled, fuelling doubts as to whether there is a real intention to promote it. Worse still, the limited resources allocated to the Federal Fund for Small Business Support were mostly mis-spent. It can be concluded that the abolition of the State Committee for the Support and Promotion of Entrepreneurship in late 1998 has, therefore, not been greatly regretted by the entrepreneurial class.
5. Because of the larger output decline, industrial enterprises are in a worse condition in Russia than in the leading transition countries. Most industrial enterprises are in a precarious state (see section 2.8).

Privatisation has not led to a significant restructuring. One reason put forward is that privatisation has not brought about a high degree of management turnover, e.g., as in the Czech Republic, therefore leaving in place the old management regardless of their business skills. However, the state of industry can not only be attributed to poor skills of managerial staff. Industrial firms in Russia are penalised both by a punitive taxation system and high utility prices, as well as having to survive while receiving less than half of the revenues in non-cash form. In some cases they are also bankrupted by the opportunistic behaviour of the management who strip them of their assets for personal gain or intentionally cause bankruptcy in order to buy the firm cheaply.

6. The payment of protection money is more widespread in Russia than in Poland or the Czech republic, but the constraint that racketeering evidently places on business activity has not been ranked among the foremost of problems identified by entrepreneurs. One reason for this may be a reluctance to discuss protection rackets, which makes any assessment of their effects difficult, but studies have generally considered the effects of racketeering a less pressing difficulty than those associated with complying with complex and contradictory legislation.

The absence of supporting networks is another reason adduced for the slow growth of small businesses in Russia, although on this point we do not have enough evidence to confirm that the situation is worse than in the leading transition countries. The importance of networks is well documented in the economic literature. In Russia, given the economic turmoil and the underdevelopment of market institutions, networks are likely to play an even greater role. These networks facilitate high trust relationships, thereby cutting transaction costs. In Russia formal networks reach a limited number of people and informal networks are poorly developed. The average entrepreneur tends to be isolated. The most relevant network is formed by the former communist nomenklatura, which is the group largely reaping the benefits of transition, while for new entrepreneurs with few connections

building a network of trusted partners will take time as trust usually evolves slowly.

Assessing the level of development of small business in St. Petersburg and in Russia as a whole requires a critical analysis of official statistics, due to the existence of several inconsistencies. In addition, the frequent changes in the methodology make it difficult to compare the data across the period. The small business share of total employment was only 12.5% in 1997 in Russia, compared with proportions varying from 38.9% to 73.5% in the OECD countries for firms with up to 100 employees. It must be taken into account that Russian and Western official data on small business are not fully comparable, as the Russian definition of small business has several limitations. For this reason its contribution to the economy is understated. The number of firms is considered to be the most reliable figure. However, a question mark remains as to the continuous growth of registered enterprises. Is this only an effect of the non-liquidation of inactive enterprises or is Goskomstat underestimating their numbers? Unfortunately there is very little evidence on this point. However, comparing employment figures with survey results suggests that Goskomstat is not adequately reflecting small business numbers.

Officially, employment in small businesses has stopped growing since 1994. The increase in the number of self-employed has not compensated for this stagnation, as they are mostly in secondary employment. Instead, survey-based results point to a continuous increase in the number of people employed by new private enterprises suggesting that the emergence of entrepreneurship has been an organic process, as in the leading transition countries, although it has been much slower in Russia where it has been restrained by the various factors listed above. Currently the sector is too small to lead to a turnaround in the Russian economy, but it is a sign that the situation will probably improve in the years to come.

How do we reconcile official data with survey-based results indicating a

constant growth in new enterprises' employment? Has the growth in employment levels of new firms been offset by a decline in the number of employees of small privatised firms? How significant is the proportion of workers in new private firms which have grown so large so that they no longer qualify no longer as small businesses? Unfortunately, we have far too little evidence on these phenomena to allow us to reach a conclusion. We can only estimate on the basis of Clarke and Kabadina's survey (see section 3.2) that the new private sector which fits small business definitions accounts for between 10% and 14% of the workforce, but this is an estimate on the basis of data that the authors consider a generalisation with little analytical value, while the only clue to the first question is that a good deal of employment in small industrial firms is in privatised or spin-off companies. Taking into account the increasing dynamism of the new private sector, which since 1994 has become more vibrant in contradiction with official data on small business, we can therefore conclude that stagnation in employment seems highly dubious, and that an underestimation would appear likely, but the extent of the probable underestimation is unknown.

Although there are no official data on survival rates, small businesses in Russia seem to be characterised by an extremely short life-span. Many firms were created in the enthusiasm to exploit the new opportunities arising from the transformation, but often lacked a clear market analysis and therefore could not survive long. The low output per firm testifies to the low development stage reached by most firms. Even taking into account the fact that Goskomstat does not capture the full extent of the grey economy in its figures, as surveys and experts' estimates suggest, the picture does not change substantially. A critical aspect of small business support is, therefore, not only to increase creation rates, but also to assist existing firms to survive and prosper. At present, a business is subject to a variety of unpredictable events which can cause its closure: bank failure with the loss of deposits; the breakdown of the banking system for an extended period, causing delays in all transactions; lack of payment by the state; continuous inspection by the tax and other departments, which can block a firm's

activity; freezing of its bank account by tax bodies without warning; fraud, against which legislation offers little protection; and considerable swings in the level of market demand. Even if profits in the small business sector are higher than in the rest of the economy, the figure is scarcely representative in view of the widespread practice of hiding profits. Conflicting surveys do not give a clear indication as to how small businesses are faring, but the prevalent picture has not been very favourable for industrial firms, while for trading firms the picture is mixed. However, the rouble devaluation of August 1998 has altered the picture in some industrial sectors, even if its effects on the different categories of small firms are puzzling. While trade firms are believed to have been affected most and industry the least, there has been by the end of 1998 a reduction in industrial employment. Employment in trade firms has, instead, remained stable. The time-span is, however, too short to have an idea of the more lasting effects of the crisis. For this it is necessary to wait until data for 1999 become available.

As far as St. Petersburg is concerned, its economy has experienced the problems typical of defence-related cities. Few of the major military factories have been able to restructure and re-orient production and this has not been helped by the chaotic state policy towards conversion. The industrial sector in the city witnessed an output drop which was more marked than in Russia in general until 1996. However, from 1997 the situation has been reversed, indicating that restructuring is taking place, at least in some sectors. A common feature of the years 1992-1996 is that regions producing more sophisticated outputs were in a more vulnerable position. New strategies for the future of the city had, therefore, to be devised in the 1990s as the city lost its importance as a defence centre, raising fears of a progressive de-industrialisation. In the early 1990s, the transformation of St. Petersburg into a free economic zone with favourable terms for foreign investors was expected to lead to an influx of foreign investment. The city, it was hoped, would revert to its pre-revolutionary role as a centre of international business and finance. However, this project, including the concession of tax and customs advantages, never got off the

ground, and the FEZ strategy was applied only to certain areas. Sobchak, mayor from 1991 to 1996, remained committed to the aim of making St. Petersburg an international centre of business and finance, but the actual results have fallen far short of expectations.

In view of the disappointing flow of foreign investment, the new mayor has paid much less attention to it, and has declared as his main objective the restructuring of the industrial sector. The industrial strategy was spelled out in the Programme of Stabilisation, but it is now clear that the results expected from the Programme will not be achieved, while a Strategic Plan has been devised to set the long-term strategy for the city economy. However, the Plan seems to be a collection of differing interest-group recommendations without a clear structure and with no apparent strategy for the realisation of its aims. A common feature of the post-transition years has been the countless plans devised by city officials. In the end, however, few of the measures indicated in these plans have been carried out. They can be considered more declarations of intent than practical policies. A command economy mentality still seems to be prevalent among economic policy makers, but this is also the consequence of the disastrous situation in which industry finds itself; this situation, therefore, acts as justification for their involvement. Active involvement to assist the industrial sector is not just a characteristic of the local administration of the city, but of most local administrations in Russia. As mentioned before, few Russian factories are doing well and the social cost of the unemployment that could result from their closure compels the local administration to listen to the cry for help of industrial managers. The actual measures implemented for the industrial sector have been the concession of subsidies to specific businesses, primarily in the forms of tax deferments, soft loans and reduction of tax rates for specific activities. The criteria for the concession of these have, however, not always been clear, and nor have the positive results, if any, of this policy. The reason for the improved performance of some sectors does not seem to lie with the help they received from the local administration, but rather the result of other factors such as foreign investment and the changing

tastes of Russian consumers. The last programme devised by Klebanov is more concrete, linking the concession of subsidies to restructuring plans which are based on reducing the firms' sizes to make them compatible with actual production levels. One of the main features of this programme is the spinning off of small companies from large enterprises. Experience from the other transition countries shows that the performance of the parent enterprise is generally enhanced once non-essential units have been spun off, but as far as St. Petersburg is concerned the past results of this process have been mixed. This programme is only beginning to be realised, so it is not yet possible to detect any results. The administration of St. Petersburg has also retained a significant role in promoting co-operation with other members of the Federation, signing agreements to exchange locally-made products for the produce of other regions in order to assure the city an adequate food supply as market signals are still not working properly.

Favouritism has been rife. Despite St. Petersburg being considered a liberal city, mayors have behaved like dictators, trying to subdue the legislative assembly and dispensing favours to their "cronies". Entrepreneurs with the right connections have been able to secure more advantageous conditions in the forms of: premises at knocked-down prices, either on rent or through privatisation; city orders; tax deferments; and exemption from inspection. The new mayor promised to put finances in order and cut down on favouritism. In effect, fiscal management has made huge steps forward. The dramatic situation in which the city administration found itself in the early nineties, when the decline in budget revenues due to the severe economic crisis was accompanied by a widening of the responsibilities that the city had to take on, was finally overcome in the late nineties with the balancing of expenditures and revenues. Even if past deficits have left a large debt, St. Petersburg was one of the few Russian cities not to default on its repayments. Success in fiscal management has, however, not meant that old methods have been eradicated. Municipal tenders are still assigned without proper competition and the strong influence of shadowy figures in local government prompted the architect of financial stabilisation to resign

in early 1999.

Despite the economic problems and the fact that the “rules of the game” have not been equal for all, St. Petersburg has, nevertheless, experienced a large growth (by Russian standards) of the small business sector since 1992, even if its level remains substantially lower than in Moscow. Small business development in Russia has been mainly centred in cities, where the economic resources to sustain small business activity are mainly concentrated. Even if we concede that data for 1992 are probably underestimated, the growth has been one of the largest in Russia. It is, however, not clear why St. Petersburg has a share of small businesses in total units, which is double the Russian average, including Moscow. Is it the result of a lower failure rate? Further analysis is required to find out why St. Petersburg differs so much from Russia on this matter.

Employment in the small business sector is approaching the levels registered in some Western countries. The much lower unemployment rate in the city compared with Russia as a whole, despite the widespread labour shedding by the large factories, can be in part attributed to the high level of development achieved by this sector in the city. The engine of this growth has been trade firms, which had only a minor role at the start of the decade. This is in contrast to that of scientific firms, the role of which in the small business sector has progressively waned. Due to the higher dislocation provoked by the fall of the planning system on its industrial sector the expansion in small business has not resulted in a better performance of the city economy compared with the rest of Russia. Considering the expansion of this sector, it is unclear why the contribution of small business to the local budget is limited, while in Russia as a whole and in Moscow the revenues provided by small businesses broadly correspond to their share of total employment. This calls into question again the reliability of these data.

This growth has taken place in the absence of a clear policy by the local government to promote small business. In general, entrepreneurs have been

staunchly critical of the local administration. The environment does not seem to be particularly business-friendly, and almost all the interviewees agree that it has not improved during recent years. In St. Petersburg financing for support measures has been limited and the little financing provided has been usually mis-managed. The measures envisaged to assist small businesses have for the most remained unapplied and the specific legislation approved in the city has had scarce effect. Local administrations in Russia have a strong influence on the business environment: a substantial share of the tax burden is determined by local bodies, as well as the rent of premises, the majority of which they own. They also have considerable autonomy in implementing regulations. In Russia, the attitude towards small business has varied greatly between different local administrations. St. Petersburg on its part has tried to be a leader in economic reforms by privatising quickly, although not always fairly, and allowing enterprises to buy land. In addition, it has striven to create a favourable business environment, lowering the profit tax and cancelling the tax on educational institutions, but these measures alone have had little effect, as the tax burden remains extremely high. The taxes on total revenues are especially crippling. Constraints are particularly strong for manufacturing firms, which are penalised by the more complicated procedure for opening a business, the existence of more supervisory bodies and the larger tax burden.

The grievances of businessmen in St. Petersburg are similar to those in other parts of Russia: high taxation, bureaucratic racketeering, a predatory tax police, the extreme difficulty of obtaining financing, the high rents required by the city administration for municipal premises, etc. The administration is in particular accused of approving legislation without exercising the proper competence. They have, instead, a high opinion of the Moscow administration. Small businesses in St. Petersburg do not have political power and have been, therefore, largely ignored by the local government until very recently. They are mostly isolated, the majority being sceptical of the efficacy of joining any association. Only one business association can boast more than 1,000 members. Nowadays, however, the development of

this sector has made it impossible for the mayor to ignore it, especially in view of the forthcoming mayoral election to be held in 2000.

In addition to the lack of support from the administration, St. Petersburg, unlike Moscow, does not enjoy a particularly high standard of living, which is only slightly higher than the national average. As these are usually mentioned as the two main factors explaining the expansion of small business in Moscow (especially the higher standard of living), it is reasonable to ask what caused small business to grow so much in St. Petersburg. One question mark hangs over the reliability of these figures, as impressionistic evidence would appear to suggest a higher standard of living in St. Petersburg than in the rest of Russia. Apart from this, in trying to answer this question, some factors can be detected which can reasonably explain the entrepreneurial boom in the city. The higher levels of educational attainment and their more "Western mentality" make them more prone to engage in entrepreneurial activity. In addition, a complex of factors (the higher foreign investment received per capita compared with Russia, the presence of a relatively large middle class - by Russian standards - the comparatively large foreign community and the tourist industry) make retail spending per capita higher than in Russia as a whole. Retail trade per capita was 26% to 50% higher than the average in Russia between 1995 and 1997, and this explains why small business growth has been mainly concentrated in services. However, the switch of consumers' preference to domestic goods in some sectors, after their initial curiosity for foreign products, helped by the fact that domestic products are improving their look, bodes well for industrial entrepreneurs. This tendency has been accelerated by the rouble devaluation. Given the unpredictability of the environment, the firms interviewed tend to be very flexible, keeping a small staff and employing extra workers when there is demand. Better-performing firms are those selling to consumers or retail outlets and having a distinct image, while those dependent on sales to industrial firms or to the city administration are faring worse.

Data collected through the questionnaire suggest that new firms are mostly in a sound financial condition and expanding production, a result which is confirmed by surveys on this sector carried out in Russia. However, the information available on the new firm sector is too limited to allow us to determine whether it is actually representative of this sector. The data provided by the organisations which completed the questionnaire can, nevertheless, provide some useful insights on small business in St. Petersburg. The fact that half of the firms have as their main competitor another small firm testifies to the greater adaptability and flexibility of new firms compared with larger ones. The sales of these firms tend to be concentrated in the local market with a negligible export component similarly to what was observed in surveys in other parts of Russia. There is, instead, greater diversity in purchases as many inputs are not locally produced.

A case apart is scientific entrepreneurship, which is analysed in the chapter on science parks. State financing has been reduced to a fraction of that in the Soviet period, forcing a great number of research workers to find other occupations or to emigrate. The idea that scientific institutions were to replace public funding with private funding has proved unfeasible for the great majority of Russian research centres. In 1997, industry was financing an even lower share of the total R&D expenditure than in 1994, despite the fall in total research expenditure. It is not surprising, therefore, that the expansion of small business in this sector ground to a halt, after an initial spurt in the early nineties, and is now contracting. Small scientific firms are, therefore, doing even worse than the small business sector as a whole.

St. Petersburg is losing its scientific potential as more and more people leave the sector and the young fail to enter it. Given their budget constraints, local administrations can do little to avert this. The problem has, however, ranked low in the priorities of the city administration. Only in the late nineties was a more focused attention given to this sector. Local universities have attempted to promote the commercialisation of research through the creation

of science parks. Most Russian science parks were founded by universities in an effort to keep researchers tied to these institutions, despite the very low salaries, by assisting them in developing their research towards commercial purposes. In Russia science parks can play a very important role given the inexperience of working in a market environment, but in the absence of comparative statistics it is hard to judge their contribution to the development of tenant firms. It may be presumed that many of these firms could not have survived long without the assistance of science parks in securing financing, and without the range of services and good-quality accommodation they provide at affordable prices. However, the usual services provided by science parks do not seem to be exploited in full. Managerial advice was found to be rather limited, but this is also due to the reluctance of the firms' managers to provide anything, but the most basic information. The transfer of technology to industry has been weak due to the limited demand for scientific products, but nevertheless the number of jobs created has been substantial.

APPENDIX

SURVEY OF SMALL PRIVATE ENTERPRISES (SPEs) IN ST. PETERSBURG

Respondents: Tulfert Carlton Danish. Siling Neklu. Karas Rams.

I) BASIC INFORMATION

	A	B	C	D	E	F	G	Total		
1. How many SPEs do you work with?	33	100	40	20	3	328	100	624		
	5%	16%	6%	3%	0%	53%	16%	100%		
2. How many of these SPEs have as legal form:										
1) Joint stock company-open	6	1					0	7	1%	
2) Joint stock company-closed	13	5	12	15		155	70	270	44%	
3) Private individual	9	90	20	5		46	0	170	27%	
4) Limited liability company			8		3	127	20	158	25%	
5) Additional Liability Company							0	0	0%	
6) Full Partnership							0	0	0%	
7) Other	3						10	13	2%***	
8) Joint venture	2							2	0%	
<b>Total</b>	<b>33</b>	<b>96</b>	<b>40</b>	<b>20</b>	<b>3</b>	<b>328</b>	<b>100</b>	<b>620</b>	<b>100%</b>	
3. How many of these SPEs were set up:										
1) Before 1992	2	10	1		2	21	5	41	7%	
2) In 1992-1993			9			76	38	123	20%	
3) In 1994-1995	15		14	2	1	112	37	181	29%	
4) In 1996-1997	16	90	16	18		119	20	279	45%	
<b>Total</b>	<b>33</b>	<b>100</b>	<b>40</b>	<b>20</b>	<b>3</b>	<b>328</b>	<b>100</b>	<b>624</b>	<b>100%</b>	
4. How many of these SPEs belong to these industrial sectors:										
1) Metallurgy							0	0	0%	
2) Chemicals	6		1				0	7	1%	
3) Engineering and Metal-working	2				1	6	0	9	2%	
4) Machine building	8					3	0	11	2%	
5) Wood/paper							16	16	3%	
6) Building materials					1	24	8	33	6%	
7) Light industry	2	100	7			4	47	160	27%	
8) Food processing	2		8	10			62	16	98	16%
9) Other*	13			10	1	213	29	266	44%	
<b>Total</b>	<b>33</b>	<b>100</b>	<b>16</b>	<b>20</b>	<b>3</b>	<b>328</b>	<b>100</b>	<b>600</b>	<b>100%</b>	
5. How many of these SPEs are:										
1) New firms	33	97	40	10	3	301	100	584	94%	
2) Former state/municipal enterprises which are now fully private				5			0	5	1%	
3) Former state/municipal enterprises which are now partially private							0	0	0%	
4) Former co-operatives/leasehold enterprises				5		27	0	32	5%	
5) Other							0	0	0%	
<b>Total</b>	<b>33</b>	<b>97</b>	<b>40</b>	<b>20</b>	<b>3</b>	<b>328</b>	<b>100</b>	<b>621</b>	<b>100%</b>	
6. How many of the new SPEs are spin-offs from larger enter:										
	10		1	5	0		10	26	13%**	
7. How many of these SPEs are owned by:										
1) Owner/manager	8	98	40	10	2	46	90	294	47%	
2) Another private company					1		5	6	1%	
3) Other local private investors	25			10		267	5	307	49%	
4) Other investors outside St. Petersburg							0	0	0%	
5) Private foreign investors						15	0	15	2%	
6) Workers							0	0	0%	
7) Other							0	0	0%	
<b>Total</b>	<b>33</b>	<b>98</b>	<b>40</b>	<b>20</b>	<b>3</b>	<b>328</b>	<b>100</b>	<b>622</b>	<b>100%</b>	
8. How many of these SPEs have as primary product:										
1) An intermediate input			1		2	245	0	248	44%	
2) A finished product	33	100	21	20	1	83	60	318	56%	
3) Other							0	0		
<b>Total</b>	<b>33</b>	<b>100</b>	<b>22</b>	<b>20</b>	<b>3</b>	<b>328</b>	<b>60</b>	<b>566</b>	<b>100%</b>	
9. How many of these SPEs are engaged also in trade and services?										
	6	50	18	20	3	328	40	465	75%**	

**II) THE ENTREPRENEURS**
**A B C D E F G Total**

10. How many of the entrepreneurs of these SPEs are:

1) Less than 30 years old		20	3		1	21	10	55	9%
2) 30-39 years old	2	60	12			203	65	342	57%
3) 40-49 years old	9	15	15		1	77	25	142	24%
4) 50-59 years old	15	5	10		1	27	0	58	10%
5) More than 59 years old	7							7	1%
<b>Total</b>	<b>33</b>	<b>100</b>	<b>40</b>	<b>0</b>	<b>3</b>	<b>328</b>	<b>100</b>	<b>604</b>	<b>100%</b>

11. How many of them are:

Excl. B,C

1) Male	32	1	15	14	3	265	80	410	66%	81%
2) Female	1	99	25	6		63	20	214	34%	19%
<b>Total</b>	<b>33</b>	<b>100</b>	<b>40</b>	<b>20</b>	<b>3</b>	<b>328</b>	<b>100</b>	<b>624</b>	<b>100%</b>	<b>100%</b>

**III) FIRMS PROFILE**
**A) TURNOVER AND PROFITS**

12. How many of these SPEs officially:

1) Generate profits	7		40	4	2	321	90	464	89%
2) Break-even	15			12	1	7	0	35	7%
3) Incur losses	11			2			10	23	4%
<b>Total</b>	<b>33</b>	<b>0</b>	<b>40</b>	<b>18</b>	<b>3</b>	<b>328</b>	<b>100</b>	<b>522</b>	<b>100%</b>

13. How many of these SPEs had the following turnover in 1997:

1) Less than 1 million new roubles		100	36				40	176	72%
2) Between 1 and 5 million new roubles			4				60	64	26%
3) Between 5 and 10 million new roubles							0	0	0%
4) More than 10 million new roubles					3		0	3	1%
<b>Total</b>	<b>0</b>	<b>100</b>	<b>40</b>	<b>0</b>	<b>3</b>	<b>0</b>	<b>100</b>	<b>243</b>	<b>100%</b>

14. How many of these SPEs have an economic situation which is:

1) Good	10		26		1	233	50	320	54%
2) Satisfactory	3	90	11		2	56	45	207	35%
3) Bad	9		2			25	5	41	7%
4) Close to bankruptcy	11		1			14	0	26	4%
<b>Total</b>	<b>33</b>	<b>90</b>	<b>40</b>	<b>0</b>	<b>3</b>	<b>328</b>	<b>100</b>	<b>594</b>	<b>100%</b>

**B) EMPLOYMENT**

15. How many of these SPEs employ full-time (officially and unofficially):

1) Less than 10 employees	12	90	30		1	77	0	210	35%
2) 11-30 employees	21	10	10		2	121	10	174	29%
3) 31-50 employees						92	40	132	22%
4) 51-100 employees						38	50	88	15%
<b>Total</b>	<b>33</b>	<b>100</b>	<b>40</b>	<b>0</b>	<b>3</b>	<b>328</b>	<b>100</b>	<b>604</b>	<b>100%</b>

**C) INVESTMENT:**

16. How many of these SPEs have made any invl 15 50 30 2 293 95 485 80%\*\*

17. Among the SPEs which have made any investment how many have:

1) Bought new equipment	15	10	20		1	26	95	167	32%
2) Bought second hand equipment		60	5		2	142	20	229	44%
3) Leased new equipment			5			81	0	86	16%
4) Leased second hand equipment		30				12	0	42	8%
<b>Total</b>	<b>15</b>	<b>100</b>	<b>30</b>	<b>0</b>	<b>3</b>	<b>261</b>	<b>115</b>	<b>524</b>	<b>100%</b>

**D) PLANT AND EQUIPMENT**

18. How many of these SPEs have equipment whose average age is:

1) New	25		20			26	0	71	18%
2) 1-3 years old	8		8			63	0	79	20%
3) 4-6 years old					1	91	0	92	23%
4) 7-10 years old			2			112	0	114	29%
5) 10-20 years old					2	21	0	23	6%
6) More than 20 years old						15	0	15	4%
<b>Total</b>	<b>33</b>	<b>0</b>	<b>30</b>	<b>0</b>	<b>3</b>	<b>328</b>	<b>0</b>	<b>394</b>	<b>100%</b>

## E) PREMISES

A B C D E F G Total

19. How many of these SPEs have:

1) Bought their premises						92	25	117	19%
2) Rented their premises	28	100	30	20	3	236	75	492	79%
3) Other	5		10					15	2%
<b>Total</b>	<b>33</b>	<b>100</b>	<b>40</b>	<b>20</b>	<b>3</b>	<b>328</b>	<b>100</b>	<b>624</b>	<b>100%</b>

## F) OUTPUT AND PRODUCTIVE CAPACITY

20. Compared with the previous year in how many of these SPEs the output has:

1) More than doubled		5				19	0	24	5%
2) Increased by between 50% and 100%	2	30	5			99	0	136	26%
3) Increased by up to 50%	3	20	25		1	181	0	230	44%
4) Remained stable	12	15	10	20	2	11	0	70	13%
5) Decreased by up to 30%	12	15				18	0	45	9%
6) Decreased by between 30% and 50%	4	10					0	14	3%
7) More than halved		5					0	5	1%
<b>Total</b>	<b>33</b>	<b>100</b>	<b>40</b>	<b>20</b>	<b>3</b>	<b>328</b>	<b>0</b>	<b>524</b>	<b>100%</b>

21. What are the main reasons for these output variations?

22. What do you forecast for the next twelve months in terms of increasing/decreasing production in SPEs ?

## G) PURCHASES

23. What percentage of the purchases of these SPEs is represented by :

1) Imports from former Soviet republics				30	20	25	10		
2) Imports from Western Europe		50		30		25	10		
3) Imports from Eastern Europe		30		20	10	10	10		
4) Imports from other foreign countries				20	?		30		
5) Local market								70	
6) Russia			90						
<b>Total</b>	<b>0</b>	<b>80</b>	<b>0</b>	<b>100</b>	<b>30</b>	<b>90</b>	<b>100</b>	<b>0</b>	<b>0</b>

## H) SALES:

24. What percentage of the output of these SPEs is sold in:

excl. B, C

1) St. Petersburg	50	90	90	100	10	25	80	52.5%	41.2%
2) North-West Russia	15	10			15		20	5.7%	5.3%
3) Other parts of Russia	25					70	0	38.4%	49.2%
4) Former Soviet republics	5						0	0.3%	0.3%
5) Eastern Europe	5				10		0	0.3%	0.4%
6) Western Europe					25		0	0.1%	0.2%
7) Other					10	5	0	2.7%	3.5%
<b>Total</b>	<b>100</b>	<b>100</b>	<b>90</b>	<b>100</b>	<b>70</b>	<b>100</b>	<b>100</b>	<b>100.0%</b>	<b>100%</b>

Danish. (B) said that 90% of the output is sold in the domestic market, without specifying where in Russia it is sold

25. How many of these SPEs have as main competitor:

1) No competitors	15						0	15	3%
2) Another small private firm	9	85	40				82	75	291
3) A large private firm		15					33	0	48
4) A state-owned enterprise	7						98	25	130
5) A foreign-owned company	2						98	0	100
6) A joint-venture								0	0
7) Other								0	0
<b>Total</b>	<b>33</b>	<b>100</b>	<b>40</b>	<b>0</b>	<b>0</b>	<b>312</b>	<b>100</b>	<b>585</b>	<b>100%</b>

26. In general, has competition for SPEs compared with 2 years ago:

1) Increased		1	1	1		1	1	5	83%
2) Remained stable	1							1	17%
3) Decreased								0	0%
<b>Total</b>	<b>1</b>	<b>1</b>	<b>1</b>	<b>1</b>	<b>0</b>	<b>1</b>	<b>1</b>	<b>6</b>	<b>1</b>

## I) EXPORT:

27. How many of these SPEs export the following share of total output:

1) 100%							0	0	0.0%
2) 80%-99%							0	0	0.0%
3) 50%-79%					1		0	1	0.2%
4) 30%-49%						2	0	2	0.5%
5) 10%-29%			2		2		0	4	0.9%
6) 1%-9%							10	10	2.4%
7) 0%	33		38	20		316	0	407	96.0%
<b>Total</b>	<b>33</b>	<b>0</b>	<b>40</b>	<b>20</b>	<b>3</b>	<b>328</b>	<b>0</b>	<b>424</b>	<b>100%</b>

**28. In your opinion, what are the main obstacles faced in exporting?**

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**29. What are the most common methods used to obtain information about foreign markets?** \_\_\_\_\_

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**30. Do you think the quality of SPEs products is superior/inferior to Western products?** \_\_\_\_\_

**31. In your opinion, how burdensome are customs formalities?**

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**32. In your opinion, how efficient are local banks in handling payments to or from a foreign country?**

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#### J) FINANCING

**33. What are the biggest problems for entrepreneurs in financing their activities?** \_\_\_\_\_

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**34. How many of these SPEs have been successful in getting a loan from a commercial bank or another financial institution ?** \_\_\_\_\_

**35. In you opinion, how difficult would it be to obtain a long-term loan (more than 1 year):**

- 1) Very easy \_\_\_\_\_
- 2) Reasonable \_\_\_\_\_
- 3) Rather difficult \_\_\_\_\_
- 4) Very difficult \_\_\_\_\_

**36. How many of these SPEs require pre-payment before shipping their goods?** \_\_\_\_\_

**37. How serious, nowadays, is the problem of overdue payments from the clients?** \_\_\_\_\_

#### IV) FIRM CONTEXT

**38. In your opinion, what are the main obstacles faced in starting a business?** \_\_\_\_\_

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**39. What are the three biggest problems affecting SPEs today?**

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**40. Is the business environment for small businesses more or less favorable now than it was three years ago?** \_\_\_\_\_

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**41. Do you forecast a rapid or a slow expansion of the private manufacturing sector in Russia?** \_\_\_\_\_

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**42. How do you judge the transport infrastructure of St. Petersburg?**

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V) POLICY TOWARDS SPMEs

**43. Do you think that the laws and the programmes enacted by federal and local authorities to promote small businesses have been beneficial and, if so, why?**

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**44. How many of these SPEs have benefited from any special programmes to help small businesses?** \_\_\_\_\_

**45. Please specify which ones have been mostly utilised:**

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**46. How do you judge the attitude of government and public officials in St. Petersburg towards private businesses?** \_\_\_\_\_

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**47. Do you think that their attitude is more or less favorable than elsewhere in Russia?**

1) If less favorable, in what way? \_\_\_\_\_

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2) If more favorable, in what way? \_\_\_\_\_

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3) Similar \_\_\_\_\_

4) Other (specify) : \_\_\_\_\_

5) Do not know \_\_\_\_\_

**48. In your opinion, what should be done to promote the small business sector and by whom ?** \_\_\_\_\_

VI) CONCLUSIONS

**49. Please add any other general comments you would like to make:**

\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

**THESE QUESTIONS WERE USED ONLY IN THE PILOT SURVEY**

	A	B	C	D	E	F	G	Total
How many of these SPEs earn the following proportion of revenues from trading:								
1) More than 50%					3	171		174
2) 30-49%								0
3) 10%-29%								0
4) Less than 10%								0
<b>Total</b>								

How many of these SPEs earn the following proportion of revenues from services:								
1) More than 50%						98		98
2) 30-49%								0
3) 10%-29%								0
4) Less than 10%					3			3
<b>Total</b>								

How many of these SPEs reinvest as a proportion of total profits								
1) More than 80%								0
2) 50-79%								0
3) 30-49%						40		40
4) Less than 30%					2	100		102
<b>Total</b>								

What proportion of the equipment owned by these SPEs was purchased from:								
1) The state enterprise where the entrepreneur worked before						20%		
2) Another state enterprise						60%		
3) The co-operative where the entrepreneur worked before								
4) Another co-operative								
5) From a local dealer of new/used equipment								
6) From a foreign dealer of new/used equipment						20%		
7) Other								
<b>Total</b>								

What percent of the customers of these SPEs is represented by								
1) State-owned enterprise						20%		
2) Private enterprise						60%		
3) Private shop, retailers								
4) Private wholesalers								
5) Foreign buyers								
6) Private individuals						20%		
7) State shops, retailers								
<b>Total</b>								

\* "other" was originally meant to define other industrial sectors, but was interpreted as including any kind of firm not belonging to the above mentioned sector. For this reason most of the firm included in this category are service firms.

\*\* this share refer to the number of firms covered by the organisations providing figures on this matters others probably include other forms in addition to the two he gave the share.

\*\*\* Ramsden probably included here all the categories except joint-stock company-closed and limited liability for which he gave figures

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\*this site is no longer available, but the article can be found in the hard copy of the newspaper

\*\* this site has vanished.

#### INTERVIEWS WERE HELD WITH:

Tatiana Alimova, leading expert of the Russian SME Resource Centre.

Natalia Bagrova, vice-director of the Department for the Development of Entrepreneurship of the Administration of the Leningrad Region.

Aleksandr Barbanel, general director of Garant (a law firm).

Elena Belova, expert of the Leontief Center.

Jury Blinov, general director of the Association for the Promotion of Innovation Activity in St. Petersburg.

Vladimir Buev, expert of the Institute for Private Sector Development and Strategic Analysis.

Kim Carlton deputy director of the Innovation Centre for the production of clothes.

Elena Danishevskaja, loan co-ordinator of the Center for Citizen Initiatives.

J.A. Duffy, advisor of the Chamber of Commerce and Industry for Amsterdam on assignment in St. Petersburg.

Nikolai Ermilov, general director of ILIP.

Constantin Eskin, deputy director of the Committee for Economy and Industrial Policy of the St. Petersburg administration.

Valentine Galenko, director of the Higher Economics School.

Sergei Gavrilov, chief redactor of Predprinimatel' Peterburga.

Ilya Karasev, vice-president of the U.S.-Russia Investment Fund.

David Kerry, country director of International Executive Service Corps.

Alexander Kizhin, deputy director of organisation at the Higher Economics School.

Larisa Kushnarenko, consultant of the Stockholm School of Economics in Russia.

Igor Lonsky, head of department of the Administration of St. Petersburg-External Affairs Committee.

Oleg Melnikov, vice-director of the technopark of the Technical University in St. Petersburg.

Alexander V. Nekludov, deputy executive of Rusnord.

Albina Nikkonen, deputy director of the Regional Fund for Scientific and Technological Development.

Yuri Nurulin, director for international relations of the Federal Programme "Engineering Network of Russia".

Thomas Oetter, a consultant working for the EBRD Small Business Fund.

Andrei Orlov, deputy chairman of the State Committee for the Support and the Promotion of Entrepreneurship.

Roman Pastukhov, president of the Union of Entrepreneurs of St. Petersburg.

Constantin Pechatnikov, director of Business Development Center of the Vyborgskii district.

Vera Popova, director of the Innovation Center of the Technical University in St. Petersburg.

Neil Ramsden, loan co-ordinator of the South Shore Bank.

Boris Salov and Boris Novikov, main redactor and general director of Innovatsii – scientific magazine.

Lev Savulkin, senior researcher of the Leontief Center.

Olga Seliuk, expert of the Institute of Social and Economic Problems of the Russian Academy of Science.

Sergei Siling, general director of the Fund for the Development of Science, Technology and Franchising.

Vladimir Spivak, director of the Svetlana Innovation Center.

Charles Towers-Clerk, BESO (British Executive Service Overseas) consultant on assignment in a Russian bank.

Joseph Tukkell, director of Institute of Innovation of the Technical University in St. Petersburg.

Vladimir Tul'vert, "main specialist" of the Innovation-Marketing Centre of the State Fund for the Development of Small Business in St. Petersburg.

Vladlena V. Yeliseeva, chief expert of the SME Development Department of the Committee for Economy and Industrial Policy Administration of St. Petersburg.

Vera Yuzkova, deputy director of Business Collaboration Center.

Igor Zaitsev, assistant of the vice-director of the technopark of the Technical University in St. Petersburg.

T. B., general director of Fitolon.

E. C., general director of Melp.

S. H., general manager of Slavia.

O. L., general director of Acvasviaz.

M. M., general director of Gefest.

T. P., director of BMN Peterburg.

E. R., chief accountant of R.